Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

DELOITTE & TOUCHE LLP,

Petitioner,

v.

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Section 11(e) of the Securities Act of 1933 provides a "negative causation" affirmative defense under which a defendant can reduce or eliminate its liability by proving that the decline in the price of a security represents depreciation in value "resulting from" factors other than misrepresentations in the part of the registration statement with respect to which the defendant's liability is asserted.

In an action against an independent auditor alleging accounting errors in its client's audited financial statements, the District Court below granted summary judgment in favor of the auditor based on the undisputed facts that there was no public disclosure prior to the filing of the suit of the existence of any alleged accounting errors, and that the decline in the price of the client's securities corresponded to a series of public announcements regarding events that occurred *after* the fiscal year covered by the financial statements on which the auditor's alleged liability was based. The Ninth Circuit reversed, holding that under Section 11(e), "[l]oss causation exists where 'the misrepresentation *touches upon the reasons* for the investment's decline in value,' " even in the absence of any disclosure regarding the allegedly erroneous financial statements.

Did the Ninth Circuit err in fashioning the "touch upon" test in light of the express requirement of Section 11(e) that the only damages recoverable for violation of the statute are those "resulting from" the misrepresentation upon which the defendant's liability is asserted?

PARTIES IN THE COURT BELOW

All parties in the court below are identified in the caption of this petition, except defendants/appellees Angelo M. Pezzani; Donald D. Kingsborough; Richard B. Stein; John B. Howenstine; Barry H. Margolis; Smith Barney, Harris, Upham & Co.; Dean Witter Reynolds, Inc.; Josephine E. Abercrombie; Worlds Of Wonder Shares Partnership; Robinson Interests, Inc.[1]

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[1] Pursuant to Rule 29.1, Deloitte & Touche LLP ("Deloitte") states as follows: Deloitte has no parent companies and has no subsidiaries that have issued stock to the public.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit, affirming in part and reversing in part the District Court's grant of summary judgment for petitioner, is reported at 35 F.3d 1407, and is reprinted as Appendix A. The opinion of the United States District Court for the Northern District of California, granting summary judgment for petitioner, is reported at 814 F. Supp. 850, and is reprinted as Appendix B.

JURISDICTION

The decision of the United States Court of Appeals for the Ninth Circuit was entered on September 15, 1994. A timely petition by plaintiffs for rehearing and suggestion for rehearing *en banc* was denied on March 27, 1995. A copy of the order denying rehearing is reprinted as Appendix C. Pursuant to Supreme Court Rule 13.2, Justice O'Connor granted Deloitte & Touche LLP's timely application for an order extending the time to file this Petition by 30 days, to and including July 25, 1995. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1). The District Court had subject matter jurisdiction pursuant to 15 U.S.C. §§ 77v and 78aa, and 28 U.S.C. § 1331. The Court of Appeals had jurisdiction over the appeal from the District Court's final judgment pursuant to 28 U.S.C. § 1291.

STATUTORY PROVISIONS INVOLVED

This case concerns the legal standards for the "loss causation" defense under Section 11(e) of the Securities Act of 1933, 15 U.S.C. § 77k(e) ("Section 11(e)"), which states in pertinent part:

> [I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value . . . resulting from such part of the registration statement[] with respect to which his liability is being asserted, . . . such portion of or all such damages shall not be recoverable.

15 U.S.C. § 77k(e).

Section 11, 15 U.S.C. § 77k ("Section 11"), which creates a private right of action in favor of individuals who purchase securities pursuant to a materially false or misleading prospectus, is reprinted in its entirety as Appendix D.

STATEMENT OF THE CASE

This action arises out of the June 1987 public offering of $80 million of convertible debentures (the "Debenture Offering") by Worlds of Wonder, Inc., a high-tech toy manufacturer ("WOW"). After the offering, WOW made a series of public disclosures, the market price of the debentures declined, and ultimately the company collapsed. Plaintiffs are a class of disappointed investors who alleged securities fraud in connection with the Debenture Offering against eleven defendants, including WOW's principal officers and directors, its underwriters,

and its independent auditor, Deloitte & Touche LLP ("Deloitte").[2]

Plaintiffs asserted a variety of claims against Deloitte, including a claim under Section 11 of the Securities Act of 1933. Section 11 creates a private right of action in favor of individuals who purchase securities issued pursuant to a materially false or misleading registration statement. The statute identifies specific classes of defendants who may be sued, and sets forth what must be proved as to each class of defendants. As to auditors and other professionals, liability may be based only upon that part of the registration statement "which purports to have been prepared or certified" by the accountant. 15 U.S.C. § 77k(a)(4) (App. D-1). Neither fraud, negligence nor reliance is required to establish a *prima facie* case.

Section 11 provides a simple arithmetic formula as the measure of damages: the difference between the amount paid for the security at the time of purchase, and the value of the security at the time suit was brought (or, if the security was sold prior to bringing suit, the amount received at the time of sale). 15 U.S.C. § 77k(e) (App. D-5). This measure of damages is markedly different from the "artificial inflation" measure of damages that some courts have fashioned, in the absence of any statutory guidance, in cases arising under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).[3] Most

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[2] On August 15, 1994, Deloitte & Touche became a registered limited liability partnership, and is now known as Deloitte & Touche LLP.

[3] This Petition does not raise the issue of what is the appropriate measure of damages in cases arising under Section 10(b).

obviously, while the statutory measure of damages under Section 11 is the difference between the price of a security at two distinct points of time (the time of purchase and the time of sale or suit), the "artificial inflation" measure is based upon the difference between the price paid for the security and its "true value" at a single point in time, the time of purchase. *See, e.g., Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir. 1987); *Harris v. American Investment Company*, 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); *Lee v. Sierra On-Line*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,420 at 90,857 (E.D. Cal. 1994).

Section 11 also provides that a defendant can reduce or eliminate its liability by proving that the decline in the price of the security from the date of purchase to the date of sale or suit resulted from factors other than the part of the registration statement with respect to which that defendant's liability is being asserted. 15 U.S.C. § 77k(e) (App. D-5). This is the section of the statute involved here.

However, we note that the Court has never endorsed the "artificial inflation" theory. Indeed, since that theory is based entirely upon analogy to common law and the broad remedial purposes of the federal securities laws, but has no statutory support, we doubt that the "artificial inflation" theory of damages can survive scrutiny under the principles enunciated by this Court most recently in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994). In any event, since Section 11 contains an express, and significantly different, measure of damages, the "artificial inflation" theory is not applicable under Section 11, whether or not it is valid under Section 10(b).

Plaintiffs' Section 11 claim against Deloitte was based upon alleged accounting errors in WOW's March 31, 1987 ("fiscal 1987") audited financial statements, the only statements in the Registration Statement that purported to be "prepared or certified" by Deloitte.[4] The alleged accounting errors primarily involved revenue recognition on sales that were recorded in fiscal 1987, but which plaintiffs claimed should have been recorded, if at all, in the fiscal year ending March 31, 1988 ("fiscal 1988").

Deloitte moved for summary judgment on the ground that the decline in the price of the WOW debentures from the date of the offering (June 7, 1987) to the end of the alleged class period (November 9, 1987) resulted entirely from factors other than the "part of the registration statement with respect to which [Deloitte's] liability [was] asserted," 15 U.S.C. § 77k(e) (App. D-5) – namely, WOW's fiscal 1987 audited financial statements. The facts were not in dispute. Deloitte showed, plaintiffs conceded, and both the District Court and the Ninth Circuit agreed, that: (1) During the period from June 7, 1987 to November 9, 1987, there was no disclosure of any kind of accounting errors in WOW's fiscal 1987 financial statements (in fact, the only claim *ever* made by anybody

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[4] Independent outside auditors neither "prepare" nor "certify" their clients' financial statements. Rather, after examining the financial statements in accordance with generally accepted auditing standards, they issue an auditor's report in the form of an opinion on the presentation of the clients' financial statements. However, for purposes of this Petition, Deloitte does not raise the issue of whether WOW's fiscal 1987 financial statements were "prepared or certified" by Deloitte within the meaning of the statute.

of accounting errors in WOW's fiscal 1987 financial statements was made by the plaintiffs themselves, when they filed their Complaint); and (2) The decline in the price of WOW's debentures from June 7, 1987 to November 9, 1987 corresponded precisely to a series of public disclosures made by WOW in fiscal 1988 concerning events that occurred in fiscal 1988 (not fiscal 1987), including: the decline in sales during fiscal 1988 of WOW's two most popular toys; the inability to deliver a successful new line of toys in fiscal 1988; a slump in the toy industry in fiscal 1988; a reduction of employees and capital expenditures in the Fall of 1988; the Company's slow Christmas season; and the drying up of WOW's sources of financing in fiscal 1988. *See, e.g., In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 855 (N.D. Cal. 1993) (App. B-4-5) ("*WOW I*").

The District Court granted Deloitte's motion for summary judgment. Following the Second Circuit's decision in *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir. 1987), the District Court held that the alleged accounting errors in WOW's fiscal 1987 financial statements did not cause the drop in the value of WOW's debentures between June 7, 1987 and November 9, 1987 because there had been no disclosure during that period of any of the alleged accounting errors in those financial statements:

> It is obvious to any investor that WOW's securities declined in value because the company was barely liquid and faced declining sales for its products, not because its financial statements

> may have been in error. Plaintiffs have absolutely no evidence to show that any part of the Debentures' decline in value was caused by Deloitte's alleged accounting errors. There was no disclosure of these errors (if indeed there were any errors) to the public at any time before this lawsuit was initiated. *Since the marketplace never knew of any alleged accounting errors, the alleged errors cannot be said to have had any effect on the Debentures' market value.*

WOW I, 814 F. Supp. at 866-867 (App. B-37) (emphasis added); *see id.* at 876 (App. B-63).

Since the decline in the debentures was caused by disclosures of matters other than the alleged errors in WOW's fiscal 1987 financial statements, the court found that Deloitte had carried its burden of proof under Section 11(e) and granted summary judgment in its favor. *Id.* at 866-67 (App. B-37-38). The Court reaffirmed its analysis in denying plaintiffs' motion for reconsideration. *Id.* at 876-77 (App. B-63-64).

The Ninth Circuit reversed. The Court specifically rejected as "faulty" and "far too narrow" the "[District Court's] premise that Deloitte's alleged errors needed to be disclosed to the market before section 11 liability could attach." *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1422 (9th Cir. 1994) (App. A-30-31) ("*WOW II*"). Instead, ignoring both the *Akerman* rule and the language of Section 11(e), and relying instead on cases decided under Section 10(b) of the Securities Exchange Act of 1934, the Court stressed the "broad nature of the 'loss causation' determination," and created its own test for loss causation under Section 11(e). *Id.* (App. A-31). It held that "[l]oss causation exists where 'the

misrepresentation *touches upon* the *reasons* for the investment's decline in value,' " even if the misrepresentation itself never came to the market's attention, and so itself could not have caused the decline in price. *Id.* (emphasis in original) (quoting *McGonigle v. Combs*, 968 F.2d 810, 821 (9th Cir. 1992), *cert. dismissed sub nom., Casares v. Spendthrift Farm, Inc.*, 113 S. Ct. 399 (1992); other citations omitted).

REASONS FOR GRANTING THE WRIT

I. SUMMARY OF ARGUMENT

This case presents an important question in the application of the "loss causation" defense under Section 11 of the Securities Act of 1933. This Court should grant certiorari for two reasons:

First, the Ninth Circuit's decision vitiates the specific statutory "loss causation" defense. Instead of applying the statute, the Ninth Circuit took a "broad" view of causation, and held that Section 11 "[l]oss causation exists where 'the misrepresentation *touches upon* the *reasons* for the investment's decline in value,' " even if the misrepresentation is never disclosed, and so could not have caused the decline in price. *WOW II*, 35 F.3d at 1422 (App. A-31) (emphasis in original) (quoting *McGonigle v. Combs*, 968 F.2d at 821; other citations omitted). This broad holding is contrary to the terms of Section 11 and to this Court's admonition in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994), to hew to the plain terms of the securities laws. The holding reflects a fundamental misunderstanding

of Section 11's place in the securities laws that requires this Court's intervention.

Second, the Ninth Circuit's decision is in direct conflict with the Second Circuit's decision in *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir. 1987) ("The price decline before disclosure may not be charged to defendants"). The Court should grant the Petition to resolve the conflict.

II. THE INTERPRETATION OF THE LOSS CAUSATION PROVISION OF SECTION 11 PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW THAT SHOULD BE SETTLED BY THIS COURT

The Ninth Circuit's decision in *WOW II* so unreasonably broadens the standard of loss causation under Section 11 that it effectively dismantles the loss causation defense that Congress provided to defendants in Section 11(e). Accordingly, that decision should be reviewed by this Court.

The correct test for loss causation under Section 11 is a patently important question. Public offerings are a common and essential means by which companies raise necessary capital for production, expansion and research. Audited financial statements are customarily included in a company's registration statement and prospectus disseminated to prospective investors. Publication of those financial statements exposes the accountants who audited them to risk of strict liability under Section 11 for alleged errors in their work.

The Ninth Circuit's "touch upon" test would make the determination of loss causation under Section 11 indistinguishable from various judicially-created standards under Section 10(b). Independent auditors of corporate financial statements, like Deloitte here, would then potentially be liable under Section 11 for millions of dollars of damages for alleged errors that are not fraudulent and of which the market is not even aware. That kind of liability is contrary to both the terms and the purpose of Section 11. It is a grievous wrong that must be reversed.

A. Section 11(e) of the Securities Act of 1933 Provides An Express "Negative Causation" Affirmative Defense

Section 11 is a narrowly-focused statute designed to impose strict liability for misleading statements in a registration statement by which securities are sold to the public. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 207-08 (1976); *WOW I*, 814 F. Supp. at 877 (App. B-64); 15 U.S.C. § 77k(a) (App. D-1). Unlike Section 10(b), Section 11 is not a "fraud" provision in the traditional sense. For example, plaintiffs need not prove that the defendant acted with "scienter." *WOW I*, 814 F. Supp. at 877 (App. B-64). Nor need they prove reliance or causation to make their *prima facie* case. *Lyne v. Arthur Andersen & Co.*, 772 F. Supp. 1064, 1067 (N.D. Ill. 1991); *Billet v. Storage Technology Corp.*, 72 F.R.D. 583, 586 n.6 (S.D.N.Y. 1976).

To ameliorate those draconian aspects of Section 11, Congress provided both a carefully tailored measure of damages and a "negative causation" affirmative defense.

The measure of damages, as described above, is the difference between the amount paid for the security at the time of purchase, and either the amount received for the security at the time of sale or the value of the security at the time suit was brought. 15 U.S.C. § 77k(e) (App. D-5). The "negative causation" affirmative defense provides that if a defendant proves that any portion or all of the damages suffered represent other than depreciation in value "resulting from such part of the registration statement" with respect to which the defendant's liability is asserted, such portion or all of such damages "shall not be recoverable." *Id.* In short, plaintiffs can recover only for the *decline* in value *resulting from* the particular alleged misleading statement.

Prior to the Ninth Circuit's decision here, the courts construed Section 11(e) to require a direct causal connection between the alleged misrepresentations and the decline in value of the security between the date of purchase and the date of sale or suit. *See, e.g., WOW I,* 814 F. Supp. at 877 (App. B-64) (" . . . Congress expressly has limited the damages [under Section 11] to those directly caused by the defendant's misleading conduct."); *In re Fortune Systems Sec. Litig.,* 680 F. Supp. 1360, 1365 (N.D. Cal. 1987) (loss causation requires that the damages be the "direct result of the misrepresentations or omissions"); *Lyne v. Arthur Andersen & Co.,* 772 F. Supp. at 1067 (plaintiffs must show that "their damage directly resulted from the defendants' wrongdoing"); *see also* H.R. Conf. Rep. No. 73-1838, 73d Cong., 2d Sess. (1934) (Congress amended the 1933 Act to include the loss causation defense of Section 11(e) "to permit the defendant in an action under section 11 to reduce the damages so that he

will not be liable for damages which he proves had no relation to his misconduct[.]"); *cf. Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir. 1987).

B. The District Court Correctly Interpreted The "Negative Causation" Affirmative Defense In Granting Summary Judgment In Favor Of Deloitte On Plaintiffs' Claim Under Section 11

Based upon the undisputed facts that there was no disclosure of any alleged accounting errors in the period from the date of the offering until the filing of the complaint after the end of the alleged class period, and that the decline in the value of WOW securities during that period corresponded exactly with a series of public disclosures made during fiscal 1988 and exclusively concerning events that took place in fiscal *1988*, the District Court correctly concluded that plaintiffs' damages did not result from the alleged accounting errors in WOW's fiscal 1987 financial statements:

> It is obvious to any investor that WOW's securities declined in value because the company was barely liquid and faced declining sales for its products, not because its financial statements may have been in error. Plaintiffs have absolutely no evidence to show that any part of the Debentures' decline in value was caused by Deloitte's alleged accounting errors. There was no disclosure of these errors (if indeed there were any errors) to the public at any time before this lawsuit was initiated. *Since the marketplace never knew of any alleged accounting errors, the*

> *alleged errors cannot be said to have had any effect on the Debentures' market value.*

WOW I, 814 F. Supp. at 866-867 (App. B-37) (emphasis added).[5]

Other courts have reached the same conclusion. *See, e.g., Akerman*, 810 F.2d at 342 ("[t]he price decline before disclosure may not be charged to" the undisclosed representation); *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 859 F. Supp. 743, 751 (S.D.N.Y. 1994) ("It is true that a 'price decline before disclosure may not be charged to defendants.' "); *see also Fortune*, 680 F. Supp at 1365-1366, 1368 (market could not react to alleged omissions until they were actually learned of).

This conclusion is unassailable as a matter of simple common sense. A market cannot react to an alleged misrepresentation whose existence has never been disclosed to it. As a result, any drop in the price of WOW's debentures could not have been the direct result of those misrepresentations, as Section 11(e) requires.

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[5] In denying plaintiffs' motion for reconsideration, the District Court reaffirmed its conclusion: "[a] defendant is entitled to summary judgment on the loss causation defense of Section 11(e) upon an unrebutted showing that the misleading nature of the statements complained of was never revealed to the market." *WOW I*, 814 F. Supp at 876 (App. B-63).

C. The "Touch Upon" Test Adopted By The Ninth Circuit Is Contrary To The Language And Intent Of The Statute

The Ninth Circuit rejected the standard articulated by the District Court as "far too narrow," and "ignor[ing] the *broad nature* of the 'loss causation' determination." *WOW II*, 35 F.3d at 1422 (App. A-31) (emphasis added). Instead, the Court fashioned the following interpretation of the loss causation provisions of Section 11:

> Loss causation [under Section 11(e)] exists where "the misrepresentation *touches upon* the *reasons* for the investment's decline in value."

Id. (App. A-31) (emphasis in original).

The problem with the "touch upon" test is that it wipes out the single element that is at the core of Section 11(e): the express statutory requirement that the decline in the price of the security "result from" the alleged violation upon which the defendant's liability is asserted (here, alleged accounting errors in WOW's fiscal 1987 financial statements). The statute *says* explicitly that the only recoverable damages are those "resulting from" the alleged misrepresentation. It says nothing about damages based on disclosures that "touch upon" the same subject matter as the alleged misrepresentation. While "touch upon" may implicate *some* relationship, it is not necessarily a *causal* relationship, particularly in a case, such as this one, against an auditor of financial statements. For instance, a plaintiff might try to argue, albeit incorrectly, that financial statements "touch upon" virtually all of the operations of a company, including revenue, sales,

expenses, assets, liabilities, and so on, and that *any* disclosure relating to a *current* fiscal year will "touch upon" many of the subjects that were reflected in the company's financial statements for the previous year. But that does not mean that the investor's damages "resulted from" any alleged accounting *errors* in the previous year's financial statements.

Indeed, there may be a very close relationship between a disclosure that causes the price of a security to drop and the subject matter of an alleged accounting error in a previous year's financial statement, without the decline "resulting from" the alleged error. For instance, a company might include a sale to Customer A in its revenue for Quarter 1, even though the sale was not actually completed until early in Quarter 2. Six months later, the company might disclose that it had written off the receivable as noncollectible to Customer A because Customer A went bankrupt and could not pay the money it owed on the sale, and the company's stock may drop as a result. In that case, the subject matter of the alleged accounting error, on the one hand, and the announcement that caused the stock to decline, on the other, would not only "touch upon" each other, but the *subject matter* arguably would be the same: the sale to Customer A. Yet it could not be said that the decline in the price of the security "resulted from" the alleged accounting error (booking revenue on the sale one quarter too early).

The "touch upon" test thus guts Section 11(e) of any meaning. Whereas the statute expressly states that the only damages recoverable under the statute are those "*resulting from* such part of the registration statement

with respect to which [a defendant's] liability is being asserted," the "touch upon" test requires only some relationship, not necessarily causal, between the subject matter of the alleged violation and the actual causes of the decline in the price of the security. The "touch upon" formula does not follow the statutory language, and it leads to results never imposed by Congress.

D. The Ninth Circuit's Reliance On Section 10(b) Cases Rather Than The Express Terms Of Section 11 Is Contrary To This Court's Decision In *Central Bank* And Related Cases

In fashioning the "touch upon" test, the Ninth Circuit did not focus on the language or legislative intent of Section 11. Instead, it relied almost exclusively on broad principles enunciated in cases that attempted to create judicially a measure of damages for implied rights of action under Section 10(b). *See WOW II*, 35 F.3d at 1422 (App. A-31), citing *McGonigle v. Combs*, 968 F.2d at 821; *Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461, 1468 (9th Cir. 1990), *rev'd on other grounds*, 112 S. Ct. 1311 (1992); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1332 (8th Cir. 1991), *aff'd*, 113 S. Ct. 1163 (1993); *see also TBG, Inc. v. Bendis*, 841 F. Supp. 1538, 1563 (D. Kan. 1993); *In re Phillips Petroleum Sec. Litig.*, 738 F. Supp. 825, 834 (D. Del. 1990).[6]

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[6] The Ninth Circuit also cited *In re Fortune Systems Sec. Litig.*, 680 F. Supp. 1360, 1365 (N.D. Cal. 1987), a Section 11 case which in turn cites dicta from *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983) (a Section 10(b) case), as part of its

The Ninth Circuit's analysis is contrary to this Court's repeated admonition that the federal courts should adhere strictly to the text of the federal securities laws in defining the conduct covered by those laws. Recently, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1448 (1994), this Court observed: "It is inconsistent with settled methodology in Section 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text." *Id.* at 1448.[7]

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analysis of the distinction between loss causation and transaction causation under Section 10(b). *Fortune*, 680 F. Supp. at 1365. The case does not support the Ninth Circuit's conclusion that misrepresentations and omissions, whose existence is not disclosed to the market, may nevertheless constitute the cause of damages under Section 11(e). The *Fortune* court held that the defendants carried their burden under Section 11(e) because there was no evidence the market learned of their alleged misstatements and omissions. *Id.* at 1368.

[7] *See also In re Jenny Craig Sec. Litig.* [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,499 at 91,386 (S.D. Cal. 1994)("The court reads *Central Bank* to generally approve of a restrictive drawing of the categories of the persons who may be liable under the federal securities laws.") (holding that institutional investors may not be held liable under Section 11 merely for selling shares to an underwriter who then sells those shares to the public); *In re Kendall Square Research Corporation Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994) ("[T]he policy undergirding [*Central Bank*] is to constrict the ambit of private actions under Section 10(b) and to thereby reduce the number of parties implicated by that statute.")

Other rulings of this Court have similarly required strict interpretation of the liability provisions of the federal securities laws, especially where, as here, the meaning of the statutory language is plain. *See, e.g., Gustafson v. Alloyd Co., Inc.*, 115 S. Ct. 1061, 1070 (1995) (restricting liability under § 12(2) to disclosure in a prospectus issued in a public offering); *Pinter v. Dahl*, 486 U.S. 622, 641 (1988) (interpreting the word "seller" in § 12(l) by "look[ing] first at the language of" the statute); *Dirks v. Securities and Exchange Commission*, 463 U.S. 646, 665 (1983) (restricting definition of insider trading); *Chiarella v. United States*, 445 U.S. 222, 227-30 (1980) (same); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 471-77 (1977) (restricting Section 10(b) actions to cases involving "manipulation" or "deception"); *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 24-42 (1977) (refusing to allow tender offerors to sue under § 14(e)); *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197-215 (Section 10(b) violations require *scienter*); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733-49 (1975) (limiting Section 10(b) actions to purchasers and sellers of securities).

These decisions respect the choices that Congress made in carefully tailoring the several remedies of the securities acts to serve varying goals, and courts must be wary of expanding them or of indiscriminately choosing among them. *Akerman v. Oryx Communications, Inc.*, 609 F. Supp. 363, 370 (D.C.N.Y. 1984), *aff'd*, 810 F.2d 336 (2d Cir. 1987). This is particularly true of Section 11. *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 200 (Congress fashioned the express civil remedies in the 1933 and 1934 Acts "on a particularized basis," and the "standard of liability created by a particular section of the Acts must therefore

rest primarily on the language of that section"); *SEC v. National Securities*, 393 U.S. 453, 466 (1969) ("Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws."). As one court observed:

> Section 11, for example, imposes liability without fault on issuers; simple negligence is enough to establish liability on the part of underwriters. The finely tuned section 11(e) test of depreciated value operates as a brake on the potentially unlimited scope of the damages that could result from these standards. Plaintiffs' suggested adoption of the far broader section 10(b) transaction-loss theory traditionally reserved for cases of deceit and fraud is the sort of analytical borrowing prohibited by the relevant authorities.

Akerman, 609 F. Supp. at 370; *see also WOW I*, 814 F. Supp. at 876-77 (App. B-63-64) ("It is no accident that the measures of damages for Section 11 violations and Rule 10b-5 violations are different . . . In order to balance the harsh, strict liability features of Section 11, Congress expressly has limited the damages to those directly caused by the defendant's misleading conduct. The remedy and the loss causation defense are provided by statute, and stand in stark contrast to the judge-made remedy for Rule 10b-5 violations.")[8]; *Versyss Inc. v. Coopers and Lybrand*, 982 F.2d

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[8] The District Court also rejected plaintiffs' attempt to bypass Section 11(e)'s statutory scheme, and recover damages for the alleged "inflation" in the price of their Debentures, as measured by the difference between the price they paid for the debentures and their "true value" at the time of purchase. *WOW I*, 814 F. Supp. at 875 (App. B-60-61). That is simply not the

653, 657 (1st Cir. 1992) ("[Section 11's] very stringency suggests that . . . some care should be taken before [it] is extended beyond its normal reading."), *cert. denied*, 113 S. Ct. 2965 (1993); *cf. LHLC Corp. v. Cluett, Peabody & Co., Inc.*, 842 F.2d 928, 931 (7th Cir. 1988) ("It is almost always possible to show that a given disclosure or nondisclosure could have affected *some* transaction, at some level of probability. Used without care, these terms ["loss causation" and "transaction causation"] hinder rather than facilitate understanding.") (emphasis in original), *cert. denied*, 488 U.S. 926 (1988).

III. THE NINTH CIRCUIT'S DECISION CONFLICTS WITH THE SECOND CIRCUIT'S DECISION IN *AKERMAN*

The decision below conflicts with the decision of the Second Circuit in *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir. 1987). This Court's guidance is

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measure of damages under Section 11. As discussed above, the only measure of damages under Section 11 is the difference between the amount paid at the time of purchase and the price of the security at the time of sale or suit, not the difference between the price and the alleged "true value" at the time of purchase. The latter is a Section 10(b) measure of damages, which, as the District Court correctly observed, has no place in Section 11. *See* WOW *I*, 814 F. Supp. at 867 (App. B-37-38). Indeed, the concepts of "artificial inflation" and "true value" are irrelevant to, and inconsistent with, Section 11(e)'s specific statutory measure, because those concepts presuppose damages without any disclosure of the existence of the misrepresentation. Section 11(e)'s measure of damages inherently requires a disclosure of the misrepresentation between the time of purchase and the time of sale or suit.

needed to secure a uniform rule on this issue and remove the potential for confusion and inconsistent judgments.[9]

The Ninth Circuit announced a "broad" view of loss causation under Section 11(e), so broad that it includes any "misrepresentation [that] *touches upon* the reasons for the investment's decline in value." *WOW II*, 35 F.3d at 1422 (App. A-31). It expressly rejected as "faulty" the "premise that Deloitte's alleged errors needed to be disclosed to the market before section 11 liability could attach." *Id.* (App. A-30). That holding directly conflicts with the Second Circuit's decision in *Akerman*.

In *Akerman*, investors sued the issuer of a prospectus that contained erroneous *pro forma* unaudited financial statements in which the company incorrectly posted a substantial transaction to the wrong month. As a result, the prospectus overstated the company's earnings. By the time the company publicly disclosed the prospectus misstatement, its stock had already declined. Plaintiffs sued under Section 11 to recover the amount of the decline occurring both prior to and subsequent to the company's public disclosure. The Second Circuit held, however, that "the price decline before disclosure may not be charged to defendants." *Akerman*, 810 F.2d at 342; *see also McMahan & Co. v. Wherehouse Entertainment, Inc.*, 859 F.

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[9] *See, e.g., McElroy v. United States*, 455 U.S. 642, 643 (1982) (certiorari granted because of "a conflict among the Circuits on this issue of statutory construction"); *Firestone Tire & Rubber Co. v. Risjord*, 449 U.S. 368, 373 (1981) (certiorari granted "to resolve a conflict among the Circuits on the appealability question" as to certain district court decisions); *Marks v. United States*, 430 U.S. 188, 189 (1977) (certiorari granted "to resolve a conflict in the Circuits").

Supp. at 751 ("It is true that a 'price decline before disclosure may not be charged to defendants.' ").

The holdings of the Ninth and Second Circuits cannot be reconciled, and a crucial aspect of the determination of damages under the federal securities laws therefore is unsettled. The uncertainty potentially affects every Section 11 case across the country. Accordingly, this Court should grant certiorari to resolve the intracircuit conflict and to settle the test for loss causation under Section 11(e).

CONCLUSION

A writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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July 25, 1995

APPENDIX A

In re WORLDS OF WONDER SECURITIES LITIGATION.

Rosetta MILLER; Walter Untermeyer; Alan Nisselson; Trudy Whitman Nisselson; Paul Greenstein; Howard H. Weston, As Trustee for the Florida Municipal, Inc., Restated Defined Benefit Trust and Plan; Sylvia Wind, on behalf of themselves and the certified class of purchasers of securities of Worlds of Wonder, Inc., Plaintiffs-Appellants,

v.

Angelo M. PEZZANI; Donald D. Kingsborough; Richard B. Stein; John B. Howenstine; Barry H. Margolis; Deloitte & Touche; Smith Barney, Harris, Upham & Co.; Dean Witter Reynolds, Inc.; Josephine E. Abercrombie; Worlds of Wonder Shares Partnership; Robinson Interests, Inc., Defendants-Appellees.

Nos. 93-15321, 93-15535.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted Aug. 10, 1994.

Decided Sept. 15, 1994.

Appeals from the United States District Court for the Northern District of California.

Before: FLETCHER, HALL, and WIGGINS, Circuit Judges.

CYNTHIA HOLCOMB HALL, Circuit Judge:

In this appeal, we consider the saga of Worlds of Wonder, Inc. ("WOW"), a toy company that sold $80

million of "junk bonds" to the investing public in June 1987. When WOW defaulted on its very first interest payment and filed for bankruptcy just six months later, rendering the securities worthless, a class of disappointed investors filed this securities-fraud action, naming as defendants WOW's officers, directors, auditors, underwriters, and major shareholders. The district court granted summary judgment in favor of all defendants and the investors appealed. After considering a myriad of issues, we affirm in part and reverse in part.

I.

In 1985, Donald Kingsborough formed WOW to manufacture and distribute "The World of Teddy Ruxpin," a product line featuring animated toy bears and accessories. Teddy Ruxpin was an immediate success, becoming a top seller for the 1985 Christmas season and generating net sales of $93 million in WOW's first fiscal year, which ended March 31, 1986. Shortly thereafter, WOW launched "Lazer Tag," a product line featuring infrared toy weapons. Lazer Tag became another instantaneous hit and, as Teddy Ruxpin continued to move briskly off the shelves, WOW posted two of the ten best-selling toys of the 1986 Christmas season. Ultimately, WOW recorded net sales of $327 million for fiscal 1987, which ended March 31, 1987.

Hoping to fund further expansion, WOW conducted a public offering of unsecured 9% convertible subordinated debentures on June 4, 1987 ("the Debenture Offering"), raising $80 million. (In common parlance, the debentures were "junk bonds" because they bore an above-market interest rate to compensate for the risk

associated with their "below investment grade" rating). This additional infusion of capital, however, proved inadequate to sustain the corporation's uncontrolled growth and, almost immediately, WOW commenced a series of public disclosures that led to sharp declines in the market price of the debentures and, eventually, to a total financial collapse.

On July 27, 1987, the corporation reported losses of $10 million for the first quarter of fiscal 1988, ending June 30, 1987. Shortly thereafter, on August 7, 1987, WOW terminated fifteen percent of its domestic workforce (fifty-five employees) and announced reductions in capital expenditures. Two months later, the corporation disclosed that it had laid off another seventeen percent of its workforce (sixty employees) and engaged in further cost-cutting measures. On November 9, 1987, WOW reported net losses of $43 million for the second quarter of fiscal 1988, ending September 30, 1987, and announced price reductions on Teddy Ruxpin and Lazer Tag. Finally, after 1987 Christmas sales fell far below projections, WOW defaulted on the first interest payment of the debentures and, shortly thereafter, filed for bankruptcy on December 21, 1987, rendering the securities worthless.

Several purchasers of WOW debentures ("the plaintiffs") subsequently filed this class action, alleging securities fraud in connection with the Debenture Offering, against (1) WOW officers Kingsborough, Angelo Pezzani, and Richard Stein ("the Officers"); (2) WOW directors John Howenstein and Barry Margolis ("the Directors"); (3) WOW's auditor Deloitte & Touche (formerly Deloitte Haskins & Sells) ("Deloitte"); (4) WOW's underwriter, Smith Barney, Harris Upham & Co. ("Smith Barney"); and

(5) WOW shareholders Josephine Abercrombie, Robinson Interests, Inc., and Worlds of Wonder Shares Partnership ("the Shareholders"). The plaintiffs claimed that the prospectus accompanying the offering ("the Debenture Prospectus") was false and misleading in violation of sections 11 and 12(2) of the Securities Act of 1933 ("1933 Act") and section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and that the Directors and Shareholders had engaged in insider trading in violation of section 10(b).

After a tortured five years of proceedings,[1] the district court granted summary judgment in favor of all defendants in an exhaustive opinion. *See In re Worlds of*

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[1] *See In re Worlds of Wonder Sec. Litig.*, 694 F.Supp. 1427 (N.D.Cal.1988) (dismissing plaintiffs' complaint without prejudice for failure to comply with Federal Rule of Civil Procedure 9(b)) *[WOW I]; In re Worlds of Wonder Sec. Litig.*, 721 F.Supp. 1140 (N.D.Cal.1989) (dismissing in part plaintiffs' amended complaint for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6)) *[WOW II]; In re Worlds of Wonder Sec. Litig.*, 1989-90 Fed.Sec.L.Rep. (CCH) ¶ 95,004, 1990 WL 61951 (N.D.Cal.1990) (certifying plaintiffs' class as those who purchased WOW securities between June 20, 1986 and November 9, 1987) *[WOW III]; In re Worlds of Wonder Sec.Litig.*, 1990 Fed.Sec.L.Rep. (CCH) ¶ 95,689, 1990 WL 260675 (N.D.Cal.1990) (denying Shareholders' initial motion for summary judgment on the insider trading claims) *[WOW IV]; In re Worlds of Wonder Sec. Litig.*, 1992 Fed.Sec.L.Rep. (CCH) ¶ 97,018, 1992 WL 330411 (N.D.Cal.1992) (granting plaintiffs' motion to quash defendants' subpoenas of absent class members) *[WOW V]; In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 208 (N.D.Cal.1992) (denying Officers' motion to quash plaintiffs' subpoena to Securities Exchange Commission for documents from an investigation of WOW) *[WOW VI]; In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 214 (N.D.Cal.1992) (denying plaintiffs' motion to compel Deloitte to produce internal audit manuals) *[WOW VII]*.

Wonder Sec. Litig., 814 F.Supp. 850 (N.D.Cal.1993) [WOW]. The court held that (1) with the possible exception of the audited 1987 financial statements, the Debenture Prospectus fully disclosed the risks of investing in WOW and that, as a result, under the "bespeaks caution" doctrine the document was not false or misleading as a matter of law; (2) even if the 1987 financial statements were false or misleading, all defendants had established affirmative defenses to section 11 liability; and (3) the plaintiffs had not established that any defendant acted with scienter sufficient to attach liability under section 10(b).

We conduct *de novo* review of the district court's grant of summary judgment. *E.g., Morris v. Newman (In re Convergent Technologies Sec. Litig.)*, 948 F.2d 507, 512 (9th Cir.1991). In so doing, we are mindful that, "[a]lthough materiality and scienter are both fact-specific issues which should ordinarily be left to the trier of fact, summary judgment may be granted in appropriate cases. Summary judgment may be defeated in a securities fraud derivative suit only by showing a genuine issue of fact with regard to a particular statement by the company or its insiders." *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 500 (9th Cir.1992) (citations and quotations omitted).

II.

We turn first to the plaintiffs' claims against the Officers, the Directors, Smith Barney, and Deloitte under section 11 of the 1933 Act, which creates a private right of action in favor of securities purchasers who rely upon a materially false or misleading prospectus. *See* 15 U.S.C.

§ 77k(a). The district court held that (1) except for possible errors in the certified 1987 financial statements that were appended to the document, "there are no statements in, or omissions from, the Debenture Prospectus that would give rise to an inference that any part of the document was false or misleading," *WOW*, 814 F.Supp. at 866, and (2) even assuming that the 1987 financial statements were false or misleading, each defendant had established an affirmative defense to section 11 liability as a matter of law.

A.

In concluding that the "textual part" of the Debenture Prospectus was not false or misleading, the district court analyzed the plaintiffs' claims of misrepresentation under the rubric of the "bespeaks caution" doctrine:

> . . . The doctrine holds that economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the document adequately discloses the risks involved. It does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous assumptions when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based. . . .
>
> In the context of a summary judgment motion, . . . [t]he doctrine holds that where a prospectus contains adequate cautionary language disclosing specific risks, no reasonable

> inference can be drawn that a statement regarding those risks was misleading.

Id. at 858, 859 (footnote omitted).[2] The court also analyzed the plaintiffs' claims in the context of information about WOW known to the market at the time of the offering:

> . . . [T]he major rating agencies classified [WOW's] debentures as "junk bonds." That this fact was widely disseminated throughout the market is reflected by the 9% interest rate for the debentures, which was substantially higher than the market rate for lower risk securities.
>
> Since WOW was widely considered in the marketplace to be a risky investment, Plaintiffs'

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[2] Noting that, "[i]f the documents are completely silent on a matter, the 'bespeaks caution' doctrine is inapplicable [because] [o]ne cannot simultaneously bespeak caution on a subject and not address it," the district court applied the *Basic* test of materiality to the plaintiffs' claims that the Debenture Prospectus omitted material information: "[F]or nondisclosure to be actionable 'there must be a *substantial* likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having *significantly* altered the 'total mix' of information made available.' " *WOW*, 814 F.Supp. at 859 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32, 108 S.Ct. 978, 983-84, 99 L.Ed.2d 194 (1988) (emphasis added)).

The court subsequently paraphrased the Basic test in imprecise terms, indicating that the alleged omissions would be material only if "a reasonable investor would have felt the information *necessary* in deciding whether to invest in WOW." *Id.* at 859 (emphasis added). The plaintiffs claim this error (substituting "necessary" for "important") mandates reversal. We disagree. The plaintiffs point to no *application* of an incorrect materiality standard and, as a result, the court's misstatement was harmless.

> allegations that statements in or omissions from the Debenture Prospectus were misleading deserve especially careful scrutiny. . . .

Id. at 864.

On appeal, the plaintiffs contend that the district court erred by adopting and applying the bespeaks caution doctrine and by granting summary judgment despite evidence indicating that the textual part of the Debenture Prospectus contained material misstatements and omissions. We consider these contentions in order.

1.

"The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law (typically in a motion to dismiss for failure to state a cause of action or a motion for summary judgment) that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud." Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 Bus.Law. 481, 482-83 (1994) [*Disclosures*]. At least six circuits have adopted some form of the doctrine. *See Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir.1994); *Kaufman v. Trump's Castle Funding (In re Donald J. Trump Casino Sec. Litig.)*, 7 F.3d 357, 371-73 (3d Cir.1993), *cert. denied*, ___ U.S. ___, 114 S.Ct. 1219, 127 L.Ed.2d 565 (1994); *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir.1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir.1991); *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir.1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir.1991).

Moreover, since the district court's opinion in this case, several trial courts in this circuit have also embraced the doctrine. *See In re Quarterdeck Office Sys., Inc. Sec. Litig.*, 854 F.Supp. 1466, 1471 (C.D.Cal.1994); *Forrester v. Microtest, Inc.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,072, 1993 WL 616688 (D.Ariz.1993); *In re Allergan Inc. Sec. Litig.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,066, 1993 WL 623321 (C.D.Cal.1993); *cf. Wade v. Industrial Funding Corp.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,144, 1993 WL 650837 (N.D.Cal.1993) (recognizing the doctrine but holding it inapplicable to the facts of the case); *Anderson v. Clow*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 97,807, 1993 WL 497212 (S.D.Cal.1993) (same).

Despite this wealth of authority, the plaintiffs breathlessly attempt to portray the bespeaks caution doctrine as a radical departure from settled law and as contrary to the letter and spirit of federal securities statutes. In reality, it is neither. Rather, the doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance. The Fifth Circuit recently explained:

> The "bespeaks caution" doctrine . . . reflects a relatively recent, ongoing, and somewhat uncertain evolution in securities law, an evolution driven by the increase in and the unique nature of fraud actions based on predictive statements. In essence, predictive statements are just what the name implies: predictions. As such, any optimistic projections contained in such statements are necessarily contingent. Thus, the "bespeaks caution" doctrine has

> developed to address situations in which optimistic projections are coupled with cautionary language – in particular, relevant specific facts or assumptions – affecting the reasonableness of reliance on and the materiality of those projections. To put it another way, the "bespeaks caution" doctrine reflects the unremarkable proposition that statements must be analyzed in context.

Rubinstein, 20 F.3d at 167 (footnotes omitted). *Accord Trump Casino*, 7 F.3d at 364 ("[The doctrine] represents new nomenclature rather than substantive change in the law."); *see generally Disclosures*, 46 Bus.Law. at 487 (explaining materiality and reliance components of the doctrine).

In this light, the district court's measured application of the bespeaks caution doctrine was entirely consistent with the above-noted authority and established Ninth Circuit precedent. *See McGonigle v. Combs*, 968 F.2d 810, 817 (9th Cir.) (affirming summary judgment in favor of defendants where "no rational jury could find the comparative figures [in the prospectus] to have been material in light of their openly hypothetical nature and the specific disclaimers" in the document), *cert. dismissed*, ___ U.S. ___, 113 S.Ct. 399, 121 L.Ed.2d 325 (1992); *Convergent Technologies*, 948 F.2d at 515, 516 (holding that a prospectus was not materially misleading because it "virtually overflows with . . . repeated emphasis of significant risk factors"); *cf. Trump Casino*, 7 F.3d at 371 (interpreting *Convergent Technologies* as "applying but not explicitly referring to the bespeaks caution doctrine"); *Moorhead*, 949 F.2d at 246 (same).

In this case, the district court applied the doctrine narrowly:

> . . . [A]n overbroad application of the doctrine would encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language. To prevent this from occurring, the bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. By contrast, blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim.

WOW, 814 F.Supp. at 858 (citations and quotations omitted); *see Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480, 489 (3d Cir.1994) ("application of the 'bespeaks caution' doctrine . . . requires that the language bespeaking caution relate directly to that to which plaintiffs claim to have been misled"). As a result, notwithstanding the plaintiffs' shrill arguments to the contrary, the court's context-specific approach entirely comports with *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S.Ct. 2749, 115 L.Ed.2d 929 (1991), in which the Supreme Court noted that "[w]hile a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil. . . . [Therefore,] publishing accurate facts . . . can render a misleading proposition too unimportant to ground liability," *id.* at 1097, 111 S.Ct. at 2760-61; *see Rubinstein*, 20 F.3d at 167-68 & nn. 26-27; *Trump Casino*, 7 F.3d at 372-73 & nn. 14-16 ("we believe that our approach comports

with the Supreme Court's reasoning in *Virginia Bankshares*"); *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir.1993) ("*Virginia Bankshares* contemplates a weighing of the true with the untrue statements . . . for liability to result").

In our view, the bespeaks caution doctrine helps "to minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement." *Romani*, 929 F.2d at 878 (quotation omitted); *see generally Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740, 95 S.Ct. 1917, 1927-28, 44 L.Ed.2d 539 (1975) ("in the field of federal securities laws governing disclosure of information[,] even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as [the plaintiff] may prevent the suit from being resolved against him by dismissal or summary judgment"). Therefore, because it is consistent both with precedent from this circuit and with well-settled principles of securities law articulated by courts across the country, we adopt the district court's formulation of the doctrine.[3]

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[3] The plaintiffs appear to contend that, if the bespeaks caution doctrine is viable, it applies only to section 10(b) claims and not to section 11 claims. This argument is plainly wrong. As noted, the doctrine is primarily an application of the materiality concept, which applies equally to both statutory provisions. *E.g., Halkin v. VeriFone Inc. (In re VeriFone Sec. Litig.)*, 11 F.3d 865, 868-69 (9th Cir.1993). Accordingly, courts have applied the doctrine to section 11 claims as well as section 10(b) claims. *See, e.g., Trump*, 7 F.3d at 365; *I. Meyer Pincus*, 936 F.2d at 761; *see generally Disclosures*, 49 Bus.Law. at 483.

2.

Turning to the merits, the plaintiffs claim the textual disclosures in the Debenture Prospectus were false or misleading in four general areas: liquidity, internal controls, revenue recognition, and sales performance. We consider each in order.

a.

The plaintiffs first contend that the prospectus was false and misleading because it stated that WOW expected to have sufficient cash to operate through March 31, 1988. The prospectus made the following disclosures regarding liquidity:

> *Seasonality of Quarterly Results.* . . . There can be no assurance that the Company can maintain sufficient flexibility with respect to its working capital needs, manufacturing capacity and supplies of raw materials, tools and components to be able to minimize the adverse effects of an unanticipated shortfall in seasonal demand. . . .
>
> *Capital Requirements.* . . . To meet seasonal working capital requirements, the Company has borrowed, and expects to continue to borrow, substantial amounts. . . . The Company anticipates that the proceeds of this offering, together with cash flow from operations, existing lines of credit and new bank credit facilities presently being negotiated, will provide sufficient funds to meet the Company's capital needs through March 31, 1988. However, if the Company is unable to obtain adequate capital from this offering and such new bank credit facilities on

> acceptable terms, its operations would be adversely affected. . . .
>
> *Liquidity and Capital Resources.* Since its inception, the Company's internally generated cash flow has not been sufficient to finance accounts receivable, inventory and capital equipment needs, as well as support growth. . . .
>
> To meet seasonal working capital requirements, management expects to continue to borrow substantial amounts under its bank line of credit and its import financing line, both of which it expects to replace or extend prior to expiration. Based on its current plan of operations, management anticipates that existing credit facilities and new bank facilities presently being negotiated, together with the proceeds of the offering of the Debentures and funds from operations, will be sufficient to meet the Company's short-term cash requirements through March 31, 1988.

After reviewing the document, the district court concluded that the prospectus "clearly bespoke caution on the serious risks WOW's liquidity crisis posed to investors. . . . Plaintiffs are not entitled to an inference that they were misled in the face of such disclosures." *WOW*, 814 F.Supp. at 866. We agree.

The plaintiffs argue that the prospectus was misleading because a reduction in size of the Debenture Offering (from $100 million to $80 million) rendered the proceeds inadequate and because WOW was so desperate for cash that the corporation became insolvent a mere sixteen days after the offering closed. Neither contention is supported by the evidence. Regarding the reduction in size, the plaintiffs presented no evidence that, at the time of

the offering, it was foreseeable that $80 million would be insufficient to enable WOW's continued operations. The defendants, on the other hand, introduced evidence indicating that the reduced amount was sufficient to meet all projected capital needs. In fact, Smith Barney specifically analyzed WOW's capital requirements based on an assumption of a $75 million offering and found that lower figure to be sufficient.

Similarly, no evidence supports the plaintiffs' claim that WOW "ran out of cash" immediately after the offering. The plaintiffs cite a memorandum by WOW's lender, First National Bank of Chicago ("First Chicago"), indicating that the corporation had exhausted its credit line shortly after the offering. That memorandum, however, does not prove what the plaintiffs suggest. It was known that WOW would need to continue to borrow after the infusion of capital. The Debenture Prospectus specifically disclosed that the corporation would continue to draw on the credit line, and in fact, several months after the offering and after conducting its own independent investigation, First Chicago renewed the line. Had WOW been insolvent, one would not expect the bank to have extended further credit. The plaintiffs make much of another allegedly damaging memorandum in which a WOW officer speculated that the corporation might suffer significant cash shortfalls in late 1987. That document, however, is not very probative because the officer wrote it *after* the Debenture Offering, apparently for the sole purposes of detailing scenarios for "contingency planning."

Given the plaintiffs' lack of probative evidence and the Debenture Prospectus' specific references to WOW's

continuing cash shortfall and borrowing requirements, the district court was correct to conclude that the prediction of liquidity was not materially misleading as a matter of law. *See Trump Casino*, 7 F.3d at 369 ("The prospectus at issue contained an abundance of warnings and cautionary language which bore directly on the prospective financial success of the [casino] and on the [venture]'s ability to repay the bonds. . . . [D]ue to the disclaimers and warnings . . . , no reasonable investor could believe anything but that the [casino] represented a rather risky, speculative investment which might yield a high rate of return, but which might alternatively result in no return or even a loss."); *Moorhead*, 949 F.2d at 245-46 & n. 2 (no material misrepresentation by projecting that a proposed venture would generate sufficient revenue to service offered bonds where there were "repeated, specific warnings of significant risk factors"). We therefore affirm the summary judgment on this issue.

b.

The plaintiffs next argue that the following Debenture Prospectus description of WOW's internal controls was materially misleading:

> *Information Systems and Control Procedures.* The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures

> and controls to meet the demand of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with the growth.

The plaintiffs contend that, in fact, WOW's internal controls at the time of the offering had "crippling deficiencies" and that "no reasonable investor reading the Prospectus would have concluded that there were any *existing* problems with controls." The district court disagreed: "Plaintiffs ignore the fact that the Prospectus included an express disclaimer that 'there can be no assurances' that WOW's existing internal controls would continue to be adequate given the rapid pace at which the company was growing. The Prospectus made no predictions to the contrary. Thus, the Prospectus adequately bespoke caution regarding this potential risk to WOW's investors. As a matter of law, Plaintiffs cannot have been misled." *WOW*, 814 F.Supp. at 865. This conclusion is correct for several reasons. First, contrary to the plaintiffs' assertions, the Debenture Prospectus did not state or imply that WOW's internal control problems were "in the past" and not ongoing. Rather, the prospectus clearly warned that the company's attempt to improve internal controls could prove to be inadequate. Second, the plaintiffs presented no evidence that WOW's internal controls at the time of the offering were materially deficient. Indeed, the allegedly "devastating" management letter issued by Deloitte (two-and-a-half months *after* the Debenture Offering) concluded that, although "significant problems" existed, WOW's internal controls had no material weaknesses. And, third, WOW probably would not have needed to disclose even serious internal-control

deficiencies. *Cf. Monroe v. Hughes*, 31 F.3d 772, 776 (9th Cir.1994) (holding that an auditor need not disclose internal controls).

The Debenture Prospectus, which noted that WOW had struggled to maintain sufficient internal controls, clearly erred on the side of *over* disclosure and was therefore not misleading. We affirm the district court on this point.

c.

The plaintiffs next argue that the Debenture Prospectus was misleading because it failed to disclose that WOW engaged in various tactics to "pump up" revenue figures without completing actual sales. Specifically, the plaintiffs contend the prospectus misleadingly omitted WOW's observance of "price protection" (the right to reimbursement in the event of post-sale price reductions), "stock balancing" (the post-sale right to exchange non-defective products for different merchandise), and "guaranteed sales" (the unqualified right to return non-defective products).

The argument regarding price protection and stock balancing is without merit for several reasons. First, the plaintiffs introduced "no evidence that, at the time of the Debenture offering, WOW's management could have foreseen that WOW would have to reduce prices to [the extent it actually did so in late 1987]. Thus, the alleged practice of price protection did not pose a foreseeable risk to WOW's investors at the time of the Debenture offering, so WOW had no duty to disclose it." *WOW*, 814 F.Supp. at 865. The speculative impact of future exchanges and price

reductions was not material. *See Hanon,* 976 F.2d at 506 ("potential action to be taken sometime in the distant future is not an item appropriately made a part of a public disclosure because of its speculativeness"). And, second, the plaintiffs concede that price protection is a common practice in the toy industry. The undisputed evidence also indicates that stock balancing is commonplace in the industry. As a result, WOW had no duty to disclose its observance of those practices. *See Hanon,* 976 F.2d at 505 (no duty to disclose a "known condition"); *Convergent Technologies,* 948 F.2d at 513 (no duty to disclose a risk "the market clearly understood"); *Schneider v. Vennard (In re Apple Computer Sec. Litig.),* 886 F.2d 1109, 1119 (9th Cir.1989) (no duty to disclose the fact that buyers could cancel orders at will because "it was well understood within the investment community that computer orders are 'soft' "), *cert. denied,* 496 U.S. 943, 110 S.Ct. 3229, 110 L.Ed.2d 676 (1990); *Vaughn v. Teledyne, Inc.,* 628 F.2d 1214, 1220 (9th Cir.1980) ("[i]t is not a violation of any securities laws to fail to disclose a result that is obvious").

Although a slightly closer call, the plaintiffs' contention regarding guaranteed sales fares no better. We agree that a company that "substantially overstate[s] its revenues by reporting consignment transactions as sales- . . . mak[es] false or misleading statements of material fact." *Malone v. Microdyne Corp.,* 26 F.3d 471, 478 (4th Cir.1994). And we acknowledge that the plaintiffs did present some evidence that WOW engaged in guaranteed sales prior to the Debenture Offering, particularly in the final quarter of fiscal 1987.

The evidence indicates, however, that Deloitte analyzed WOW's sales practices and concluded that, "[w]hile it is true that on a few occasions prior to the 1987 audit, WOW made the business decision to permit customers to return or exchange nondefective products, these returns were minimal in number, and did not have a material impact on WOW's financial statements taken as a whole." As the district court noted, "[j]ust because some of WOW's customers were allowed a refund does not mean that . . . WOW had a practice of offering guaranteed sales to all its customers. Giving an unsatisfied customer a refund is a normal business method of dealing with an unsatisfied customer. It is not a violation of securities laws for WOW to fail to disclose such an obvious practice to potential investors." *WOW*, 814 F.Supp. at 862.

The plaintiffs' evidence of guaranteed sales is speculative, nebulous, and nowhere purports to quantify the degree to which WOW engaged in this "normal business" practice. As such, it does not rise to the level of a material omission. *Cf. Malone*, 26 F.3d at 478 (expert testimony specifically indicated that the company's undisclosed consignment sales accounted for thirteen percent of total revenue and made financial statements "not only misleading, but misleading in a material way"). The plaintiffs cannot defeat summary judgment merely by accusing WOW of trying to post favorable financial figures. *See Convergent Technologies*, 948 F.2d at 515 ("[P]laintiffs do not explain why [the issuer] would want to exclude such [one-time] sales. Plaintiffs suggest [the issuer] made the sales in the fourth quarter to post better numbers on its year-end financials and thus further its scheme to inflate

its stock price. Plaintiffs provide no evidence to support this suggestion."); *Vaughn*, 628 F.2d at 1221 ("Corporate officials are under no duty to disclose their precise motive or purpose for engaging in a particular course of action, so long as the motive is not manipulative or deceptive").

We therefore conclude the district court correctly held that the Debenture Prospectus was not misleading on this issue.

d.

Finally, the plaintiffs argue that the following Debenture Prospectus disclosures misstated WOW's performance in the first quarter of fiscal 1988 and generally hid the fact that, at the time of the Debenture Offering, sales of and demand for WOW products had declined precipitously:

> *Seasonality of Quarterly Results.* . . . The Company anticipates that net sales for the quarter ending June 30, 1987 will be less than those for each of the prior three quarters, and the Company expects to report a loss for the quarter. . . .
>
> *Net Sales.* . . . Because sales of toys are highly seasonal, the Company would generally expect net sales to be lower in the first half of the calendar year. The Company's net sales in the first quarter of fiscal 1987 were lower than net sales in each of the preceding two quarters. Similarly, the Company expects net sales for the first quarter of fiscal 1988 to be lower than sales for each of the prior three quarters. At the same

> time, the Company is continuing to expand its operations in anticipation of the Christmas selling season. As a result, the Company expects to report a net loss for the first quarter of fiscal 1988 proportionally greater than the net loss reported for the first quarter of fiscal 1987.

The plaintiffs contend the prospectus was misleading because it did not state that (1) WOW's performance in the first quarter (which ended a month *after* the Debenture Offering) would be "substantially" lower than the first quarter of the preceding year or (2) WOW's net quarterly loss would be "disproportionally greater" than that of the prior year. We reject this argument for several reasons.

First, as Smith Barney explains, "[t]he only reasonable reading [of the prospectus] is that, in light of the *lower* first quarter sales and the *higher* first quarter operating expenses the company was then expecting, WOW's net loss . . . was expected to constitute a 'greater proportion' of net revenue than . . . during the first quarter of 1987." The prospectus did not imply that WOW's first quarter 1988 losses would be proportional to its first quarter 1987 losses.

Second, the prospectus clearly warned that WOW expected lower net sales. WOW was under no duty to disclose the precise extent of the anticipated revenue drop. *See Backman v. Polaroid Corp.*, 910 F.2d 10, 16 (1st Cir.1990) (en banc) ("Disclosing that [a product] was being sold below cost was not misleading by reason of not disclosing how much below."). The plaintiffs complain that the prospectus failed to disclose the extent to which first quarter sales lagged behind WOW's internal

projections. The quarter, however, was not yet complete; had WOW actually disclosed its internal business plan, the plaintiffs probably would now be contending that no basis existed for such a prediction. *Cf. Convergent Technologies*, 948 F.2d at 516 ("It is just good general business practice to make . . . projections for internal corporate use. There is no evidence, however, that the estimates were made with such reasonable certainty even to *allow* them to be disclosed to the public.") (quotation omitted).

The plaintiffs also argue that the Debenture Prospectus violated section 11 by failing generally to reveal "WOW's crisis of sales and demand." The district court disagreed: "Plaintiffs submit no admissible evidence to show that WOW's sales had decreased so dramatically at the time of the Debenture offering that WOW's management could have known about, and thus would have had a duty to disclose, the impending collapse of Lazer Tag sales. Plaintiffs cannot use the benefit of 20-20 hindsight to turn management's business judgment into securities fraud." *WOW*, 814 F.Supp. at 865. We agree.

The plaintiffs argue that WOW's sales, for Lazer Tag in particular, began a dramatic collapse in January 1987 and that, because revenues prior to the Debenture Offering fell below WOW's internal business plan, WOW was required to disclose that "fact" in the Debenture Prospectus. The prospectus, however, fully disclosed WOW's sales for each of the eight completed fiscal quarters of its existence (through March 31, 1987). This disclosure revealed a significant decline in both net sales and net income for the first three months of 1987. The plaintiffs' complaint that WOW should have disclosed the ramifications of that drop in sales (*i.e.*, that the decline was due to

more than "normal seasonality") is without merit. *See Convergent Technologies*, 948 F.2d at 513 ("The challenged statements do not imply any comparison between the rate of past and future growth. They simply report past performance and assert specific limited predictions for the future."); *see generally Trump Casino*, 7 F.3d at 375 ("The federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors, whether favorably or unfavorably.").

Perhaps realizing this, the plaintiffs concentrate their argument on the not-completed first quarter of fiscal 1988. As noted above, the Debenture Prospectus disclosed that WOW would suffer a net loss in that quarter. Nevertheless, the plaintiffs argue that the corporation should have informed investors that demand for its products was, in fact, "dead." The evidence, however, indicates that all interested parties (including the Officers, Smith Barney, and WOW's retailers) anticipated that WOW's products would again sell well in fiscal 1988. Although first quarter sales were disappointing, the parties reasonably discounted WOW's performance in the first two months of that quarter as being relatively inconsequential. Indeed, WOW projected those two months to account for only four percent of its revenue for the year.

Just four days prior to the Debenture Offering, WOW commenced a production schedule implementing the corporation's optimistic business plan, which projected $542 million in sales. As the Officers note, if demand actually had dried up, the "[p]laintiffs cannot explain why WOW's entire senior and middle management would have lied to themselves about the Company's business outlook." *See Apple Computer*, 886 F.2d at 1117 ("[the

corporation]'s massive investment in [a new product] demonstrates this good faith" belief that it will succeed). The plaintiffs presented no admissible evidence to the contrary.[4] In sum, their argument distills to a contention that WOW should have predicted the collapse in sales that occurred in late 1987, long after the Debenture Offering. The corporation had no duty to do so. *See VeriFone*, 11 F.3d at 869 ("These alleged nondisclosures are, in substance, failures to make a forecast of future events. Put another way, what the complaint states is that [the issuer] omitted to state the 'fact' that future prospects were not as bright as past performance. Absent allegations that [the issuer] withheld financial data or other existing facts from which forecasts are typically derived, the alleged omissions are not of material, actual facts.

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[4] The plaintiffs did submit the declaration of John Forsythe, a former WOW collections manager, who stated that "I understood that it was common knowledge among the WOW sales personnel . . . that demand for products in the Lazer Tag line had collapsed" and that "I understood on the basis of my conversations with WOW sales personnel . . . that the 'pipelines were stuffed' with Lazer Tag kits." The district court, however, excluded this evidence because "Forsythe had no responsibility for WOW's sales, so he has no personal knowledge of this fact and could not testify to it at trial. If he were to testify to the fact that various retailers told him sales were poor, it would be inadmissable hearsay." WOW, 814 F.Supp. at 865 n. 12.

This ruling was not an abuse of discretion. *See McGonigle*, 968 F.2d at 818 n. 6 ("Evidentiary rulings are not reversible absent clear abuse of discretion."); *In re Convergent Technologies Second Half 1984 Sec. Litig.*, No. C-85-20130-SW, 1988 WL 215412 (N.D.Cal. Jan. 10, 1990) (excluding as hearsay the declaration of a company's former collections officer regarding "false sales . . . to inflate the stock price"), *aff'd mem.*, 942 F.2d 791 (9th Cir.1991).

Therefore, the forecasts need not have been disclosed, and the failure to make the omitted forecasts did not render the other statements that were made misleading."). We affirm the district court on this point.

e.

The avalanche of documents presented by the plaintiffs does little more than illustrate the fact that, at the time of the Debenture Offering, WOW's future was uncertain. The Debenture Prospectus adequately disclosed this fact and the market, which characterized the debentures as "junk bonds," realized it. As a result, we agree with the district court's summary of the plaintiffs' section 11 case:

> When a company fails, it does not automatically mean that a violation of the securities laws has occurred. There are a number of risks involved whenever one invests in any company. . . . The securities laws do not insulate investors against stock downturns which are caused by events not foreseeable to the company's management, nor do they provide insurance against risks that were disclosed to investors at the time they purchased the securities.
>
> In this case, WOW's investors took a gamble, as do all investors. They lost. Holders of shares and Debentures knew that WOW was not a diversified company. Its success was based on only two major products. . . . And, WOW's precarious cash position was not concealed from these investors. . . . It was obvious to any reasonable investor that if either of WOW's two

> products were to lose favor with consumers, the company would be devastated. . . .
>
> Plaintiffs have submitted hundreds of pages to this court in an effort to create a genuine issue of fact. Using tortured reasoning, convolution of the issues, and the benefit of hindsight, they point to the most innocuous of optimistic language, and the most immaterial of omitted facts, and claim that they were somehow misled as to the nature of their investment. [That is not sufficient].

WOW, 814 F.Supp. at 873. We affirm the district court's summary judgment in favor of the defendants regarding the textual part of the Debenture Prospectus.

B.

As noted above, the district court recognized that the "[p]laintiffs allege numerous errors in the financial statements for 1987, included in the back pages of the Debenture Prospectus," *WOW*, 814 F.Supp. at 864 (footnote omitted), and, as a result, decided to "conserv[e] judicial resources by assuming *arguendo* that the statements are in error, because summary judgment for defendants is clearly appropriate on other grounds," *id.* at 867 n. 13. We conclude that the "other grounds" on which the district court relied were sufficient to support summary judgment for all defendants except Deloitte.

1.

Because the audited 1987 financial statements were "certified" by Deloitte within the meaning of section 11,

every defendant other than the auditor can escape section 11 liability for the statements by establishing that they "had no reasonable ground to believe and did not believe . . . that the ["expertised"] statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. Sec. 77k(b)(3)(C). *E.g., In re Software Toolworks, Inc. Sec. Litig.*, 789 F.Supp. 1489, 1498 (N.D.Cal.1992), *appeal dismissed*, 16 F.3d 1073 (9th Cir.1994). The district court held that all defendants had proven this "reliance" defense:

> . . . [T]he issues are enormously complex on the question of whether Deloitte's recognition of revenues was in accordance with the standards of the accounting profession. The parties have generated well over 100 pages of conflicting expert testimony on these issues alone. It is absurd in these circumstances for Plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistake by Deloitte. Therefore, even if there are errors in the financial statements, no defendant except Deloitte can be liable under section 11 on that basis.

WOW, 814 F.Supp. at 863-64. We agree.

The plaintiffs contend that the Officers, the Directors, and Smith Barney cannot invoke section 11's reliance defense because they "not only knew of the transactions which caused WOW's audited financial statements to be [allegedly] false and misleading, but actively structured and participated in those transactions." This argument entirely misses the point of the district court's ruling.

As the court recognized, "[p]laintiffs have admitted that WOW's management made full disclosure to Deloitte of all relevant information regarding the questioned transactions." *WOW*, 814 F.Supp. at 864. After disclosing the nature of the transactions, the defendants relied on Deloitte's *accounting decisions* (to permit revenue recognition) about the sales. Those expert decisions, which underlie the plaintiffs' attack on the financial statements, represent precisely the type of "certified" information on which section 11 permits non-experts to rely. *See Software Toolworks*, 789 F.Supp. at 1498 ("Given the complexity of the accounting issues, the Underwriters were entitled to rely on Deloitte's expertise.").

We therefore affirm the district court's conclusion that all defendants except Deloitte were immunized from section 11 liability for errors in the 1987 financial statements.

2.

Regarding Deloitte, the district court concluded that the auditor had established a "loss causation" defense:

> Damages for a Section 11 violation are measured by the difference between the amount paid for the security and its price at either the time it was sold or the date the Section 11 claim was filed. *See* 15 U.S.C. Sec. 77k(e). Section 11(e), however, provides that:
>
> > [I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value . . . resulting from such part of the registration statement[ ]

> with respect to which his liability is being asserted, . . . such portion or all of such damages shall not be recoverable.

Id. The defendant has the burden of proof on this defense. *Id.* Though it has been recognized by courts as a "heavy burden," it is not insurmountable, and courts have awarded summary judgment to the defendant in appropriate cases. *See In re Fortune Sys. Sec. Litig.*, 680 F.Supp. 1360, 1364-65 (N.D.Cal.1987).

This is such a case. It is obvious to any investor that WOW's securities declined in value because the company was barely liquid and faced declining sales for its products, not because its financial statements may have been in error. Plaintiffs have absolutely no evidence to show that any part of the Debenture's decline in value was caused by Deloitte's alleged accounting errors. There was no disclosure of these errors (if indeed there were any errors) to the public at any time before this lawsuit was initiated. Since the marketplace never knew of any alleged accounting errors, the alleged errors cannot be said to have had any effect on the Debentures' market value.

WOW, 814 F.Supp. at 866-67. Because this analysis is based upon the faulty premise that Deloitte's alleged errors needed to be disclosed to the market before section 11 liability could attach, we reverse the summary judgment on this issue.

To establish a "loss causation" defense under section 11(e), Deloitte needed to prove "that the depreciation in value [of the debentures] resulted from factors other than the [alleged] material misstatement in the [1987 financial]

statement." *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340 (2d Cir.1987). *Accord, e.g., Fortune Sys.*, 680 F.Supp. at 1364. The district court concluded that Deloitte met this burden by showing that WOW never disclosed to the market the fact that the 1987 financial statements contained material errors. This analysis was, quite simply, far too narrow.

Loss causation exists where "the misrepresentation *touches upon* the *reasons* for the investment's decline in value." *McGonigle*, 968 F.2d at 821 (emphasis added) (quotation omitted) (section 10(b) case). *Accord, e.g., Fortune Sys.*, 680 F.Supp. at 1365 (section 11 case); *see generally Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461, 1468 (9th Cir.1990) ("what securities lawyers call 'loss causation' *is* the standard common law fraud rule" of "proximate causation") (quotation omitted) (section 10(b) case), *rev'd on other grounds*, ___ U.S. ___, 112 S.Ct. 1311, 117 L.Ed.2d 532 (1992); *cf. Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1332 (8th Cir.1991) ("all the Class needed to show [to establish 'loss causation'] was that the [issuer]'s bankruptcy was somehow *'related' to* Arthur Young's nondisclosure") (emphasis added) (section 10(b) case), *aff'd*, ___ U.S. ___, 113 S.Ct. 1163, 122 L.Ed.2d 525 (1993). The district court's application of section 11(e) ignores the broad nature of the "loss causation" determination. Indeed, the plaintiffs rightly note that, if correct, "[t]he district court's interpretation would eviscerate the statute. Companies and their auditors could immunize themselves from § 11 liability for false and even fraudulent financial statements simply by refusing to admit their falsity (or refusing to include in their adverse public disclosures information that would 'clue in the

market' to their falsity) prior to the time a § 11 suit is filed."

Under the correct inquiry, summary judgment was clearly inappropriate in this case. As Deloitte acknowledges, "the decline in the value of WOW's investment securities . . . corresponded precisely to a series of fiscal 1988 public disclosures." The plaintiffs introduced expert testimony that those disclosures *directly related* to the transactions for which Deloitte allegedly made erroneous accounting determinations, and that, as a result, Deloitte's alleged errors "touched upon" the reasons for the decline in the value of WOW's debentures. Several examples are illustrative:

> *The plaintiffs allege that Deloitte improperly recognized revenue on 1987 "sales" for which WOW offered price protection. WOW's subsequently announced losses for the second quarter of fiscal 1988 included a $13.2 million reserve for price protection in connection with the 1987 transactions. Following disclosure of those losses, the market price of the debentures declined.
>
> *The plaintiffs allege that Deloitte improperly recognized revenue on the 1987 "K-Mart Transaction," in which WOW offered the retailer extended payment terms, stock balancing, and guaranteed sales. When WOW subsequently announced losses for the second quarter of fiscal 1988, including a $9.9 million charge for K-Mart's cancellation of the "sales," the market price of the debentures declined.
>
> *The plaintiffs allege that Deloitte improperly failed to account for WOW's excess and obsolete inventory. When WOW subsequently

announced losses for the second quarter of fiscal 1988, including the creation of a $12 million inventory reserve, the market price of the debentures declined.[5]

In light of that evidence, the auditor clearly did not overcome, as matter of law, "Congress' desire to allocate to the defendants the risk of uncertainty in [section 11(e)] cases." *Akerman*, 810 F.2d at 341.[6] We therefore reverse the

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[5] The district court said that it "failed to see the logic in plaintiffs' argument [on the loss causation issue]. The amount of revenue posted by a company during a prior year is a number that exists only on paper to reflect total sales during that year. The amount of actual cash the company has access to at the moment is not necessarily related to its total sales in the previous year. . . . The market [therefore] would not interpret WOW's running out of cash as a signal that its revenues for the previous year were overstated." *WOW*, 814 F.Supp. at 877.

Although undoubtedly true, the court's observations are wholly inapposite to the plaintiffs' argument. The plaintiffs contend that Deloitte's alleged errors directly affected the market price of the debentures by causing the creation of reserves to account for "false sales" and, in some cases, actually enabling WOW to consummate transactions it otherwise never would have attempted. That contention states a direct correlation between the alleged misstatements (faulty revenue recognition) and the loss (the decline in debenture price) and, accordingly, is sufficient to nullify Deloitte's "loss causation" defense on summary judgment.

[6] The plaintiffs also introduced evidence that Deloitte's alleged misrepresentations artificially inflated the offering price of the debentures. "Properly applied, the concept of loss causation will permit the plaintiff to recover only that damage caused by the misrepresentation: the amount paid over the true value." *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 650 F.Supp. 1346, 1354 (W.D.Wash.1986). *See McGonigle*, 968 F.2d at 821 (loss causation exists where "the alleged omissions adversely

district court's holding that Deloitte established a "loss causation" defense as a matter of law and remand for a trial on the merits of (1) whether the 1987 financial statements were in fact misleading (an issue not decided by the court) and (2) whether Deloitte can affirmatively establish a loss causation defense.

III.

The plaintiffs asserted claims against Smith Barney under section 12(2) of the 1933 Act, which imposes additional liability on parties who sell securities with a false or misleading prospectus. *See* 15 U.S.C. § 771(2). The district court concluded that the plaintiffs' claims were meritless:

> The analysis this court applied to Plaintiffs' Section 11 claims . . . applies equally to Plaintiffs' claims under Section 12(2). This court

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affected the objective value of the[ ] investment"); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir.1987) (plaintiff may recover "the difference between the purchase price and the value of the stock at the date of purchase") (quotation omitted). Deloitte argued that this "artificial inflation" analysis, which has arisen in section 10(b) cases, is inconsistent with section 11(e), and the district court agreed. *See WOW*, 814 F.Supp. at 875-77.

Although we do not decide this issue because a remand is appropriate for other reasons, we do note that section 11(e) specifically provides that loss causation exists where a "depreciation in value" "result[s]" from a misleading statement in a prospectus. Although no court has considered section 11 loss causation in the manner urged by the plaintiffs, neither Deloitte nor the district court cited any authority purporting to disregard the plain statutory language in such a case.

> repeats its holding that there are no material omissions from the prospectus, aside from possible errors in the 1987 financial statements. . . .
>
> Regarding the alleged errors in the 1987 financial statements, . . . Smith Barney specifically sought and received assurances from Deloitte on the facts that supported Deloitte's decision to recognize revenue on the questioned transactions. Thus, Smith Barney clearly exercised reasonable care, and it did not have reason to know that there were any errors in the financial statements.

WOW, 814 F.Supp. at 867-68. We agree.

As noted above, the textual part of the Debenture Prospectus contains no material misstatements or omissions. Accordingly, Smith Barney has no section 12(2) liability for those disclosures.

Regarding the 1987 financial statements, we conclude that the plaintiffs waived their right to appeal the district court's determination that Smith Barney established a "due diligence" defense. In their eighty-page opening brief, the plaintiffs' only reference to section 12(2) was in a footnote, alleging that "[a]ll arguments asserted herein with respect to the § 11 claim against Smith Barney are applicable to the § 12(2) . . . claims against this defendant." Nowhere in their brief, however, did the plaintiffs discuss "due diligence." Indeed, even in their reply brief, the plaintiffs only mentioned due diligence with regard to the "textual parts of the Prospectus" and *not* with regard to the 1987 financial statements. This lack of argument waives an appeal of the issue. *E.g., Officers For Justice v. Civil Serv. Comm'n*, 979 F.2d 721, 726 (9th

Cir.1992) ("We will not ordinarily consider matters on appeal that are not specifically and distinctly raised and argued in appellant's opening brief.") (quotation omitted), *cert. denied*, ___ U.S. ___, 113 S.Ct. 1645, 123 L.Ed.2d 267 (1993).

We therefore affirm the district court's summary judgment in favor of Smith Barney on the section 12(2) claim.

IV.

Finally, the plaintiffs asserted claims against all defendants under section 10(b) and Rule 10b-5 of the 1934 Act, which provide liability for deceptive conduct in connection with the sale of securities. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. To establish section 10(b) liability, the plaintiffs must show that the defendants acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n. 12, 96 S.Ct. 1375, 1381 n. 12, 47 L.Ed.2d 668 (1976); *see Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir.1990) (en banc) (holding that recklessness constitutes scienter under section 10(b)), *cert. denied*, 499 U.S. 976, 111 S.Ct. 1621, 113 L.Ed.2d 719 (1991).

A.

The district court held that the plaintiffs had no section 10(b) claims based on the textual part of the prospectus because, "as a matter of law, there are no misleading statements in, or material omissions from, the

Debenture Prospectus, aside from possible errors by Deloitte in the 1987 financial statements." *WOW*, 814 F.Supp. at 869. Because the standard of materiality is the same under section 10(b) as it is under section 11, *e.g.*, *VeriFone*, 11 F.3d at 868-69, we affirm this conclusion for the reasons stated above.

B.

The plaintiffs, however, also asserted section 10(b) claims based "on alleged fraudulent conduct by [some] defendants other than the [textual part of the] prospectuses." *WOW*, 814 F.Supp. at 869. The district court held that summary judgment was appropriate for all defendants on these claims because the plaintiffs could not establish scienter.

1.

With regard to the Officers, the court concluded as follows:

> . . . Plaintiffs allege in conclusory fashion that the Officer Defendants violated Rule 10b-5 by misleading "press releases, filings with the SEC, statements to analysts, etc." The Officers Defendants[']overall pattern of conduct, though, rebuts any inference of knowing or reckless conduct on their part. If WOW's officers were bent on committing fraud, it is not likely that they would have provided such detailed risk disclosure in the prospectuses. Furthermore, if, as Plaintiffs allege, the Officers knew that WOW was heading for financial disaster, they probably would have bailed out of their

> substantial holdings. Each of the Officer Defendants, by contrast, held onto most of their WOW stock and incurred the same large losses as did the Plaintiffs themselves. . . .

Id. at 869. We agree.

The plaintiffs produced no direct evidence of any scienter on the part of the Officers. Rather, the plaintiffs seek to rely on speculative inferences that arise from the Officers' allegedly suspicious conduct. The Officers, however, conclusively rebutted any such inference that might have been permissible. *See generally DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.) ("The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. . . . Because only a fraction of financial deteriorations reflects fraud, [however,] plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud."), *cert. denied*, 498 U.S. 941, 111 S.Ct. 347, 112 L.Ed.2d 312 (1990).

The detailed risk disclosure in the Debenture Prospectus negates an inference of scienter. *E.g., Ferber v. Travelers Corp.*, 802 F.Supp. 698, 714 (D.Conn.1992) ("defendants' provision of adverse information to the public by way of disclosures negates an inference that they acted with an inten[t] to defraud") (quotation omitted); *see also DiLeo*, 901 F.2d at 629 ("People sometimes act irrationally, but indulging inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another

has behaved irrationally has to make a strong case."). Similarly, the Officers' minimal sales of stock also negates an inference of scienter. *See Apple Computer,* 886 F.2d at 1117 ("credible and wholly innocent explanations for the stock sales . . . are sufficient to defeat any inference of bad faith").

Moreover, the Officers' post-offering efforts to continue WOW's expansion, including increased expenditures on advertising and product development, evince their good faith belief in WOW's prospects for success. *See id.* at 1118 ("Any remote inference of bad faith arising from the defendants' stock sales is completely dispelled by the defendants' overall pattern of conduct. Throughout the class period, the defendants continued to stake much of [the corporation]'s future on the success [of a new product], pouring millions of dollars into product development, market research, and promotions. At the same time, defendants retained the great bulk of their holdings, and held on in the face of a decline of almost 75% following disclosure of [the product]'s disappointing sales. . . . We cannot conclude that this conduct is so inconsistent with the defendants' expressed optimism as to raise a triable issue regarding the defendants' good faith.").

We affirm the district court's conclusion that the plaintiffs had not established scienter on the part of the Officers.

2.

Consistent with its section 11 analysis, the district court recognized that issues of fact existed as to whether

Deloitte was liable for material misstatements or omissions in the 1987 financial statements. The court held, however, that summary judgment was appropriate because Deloitte had not acted with scienter:

> Deloitte has submitted evidence showing that it extensively investigated, carefully addressed, reasonably resolved, and thoroughly documented every transaction where Plaintiffs allege revenue was improperly recognized. Also, Deloitte submits the declarations of its accountants that recognition of the revenue was proper in accordance with Generally Accepted Accounting Principles ("GAAP"). . . .
>
> Plaintiffs respond . . . with the declaration of [alleged expert] Albert Rossi. . . . Rossi's testimony, in substance, is that for everything Deloitte's accountants did, he would have done more, and that in his opinion, the revenues were improperly recognized under GAAP. Rossi concludes that "[t]he danger that Deloitte's audit opinion and the financial statements which Deloitte audited would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it."
>
> As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case. *Apple Computer,* 886 F.2d at 1116. "However, where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert.' " *Id.* An expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any

> inference of bad faith. *See Software Toolworks*, 789 F.Supp. at 1504 n. 30.
>
> Here, Rossi's conclusory opinion . . . is not based on specific facts that shed light on the mental state of Deloitte's auditors. . . . Rather, Rossi is drawing his own conclusion based on a record that conclusively rebuts any inference of scienter. . . . As such, Rossi's opinion is more probative of Plaintiff's desperation to keep Deloitte, a "deep pocket," involved in this lawsuit than it is on the issue of whether Deloitte acted with scienter.

WOW, 814 F.Supp. at 870-71. We agree.

The plaintiffs presented no direct evidence that Deloitte acted with scienter. Nevertheless, the plaintiffs contend that summary judgment was inappropriate because their "expert" opined that Deloitte had done so. Inspection of the expert's declaration, however, reveals that he made an impermissible leap in logic to reach this conclusion.

Deloitte freely acknowledges that it had "full information" about the terms of the disputed transactions. Yet, as Deloitte explains, that knowledge is not dispositive:

> . . . Deloitte knew many facts because it did a diligent audit. But the issue is not whether Deloitte knew facts about transactions; it is whether Deloitte had "actual knowledge" of a misrepresentation, or whether Deloitte's resolution of the accounting issues presented by those facts was such "an extreme departure" from reasonable accounting practice that it "knew or had to have known" that its conclusions would mislead investors. *Hollinger*, 914 F.2d at 1569.

Rossi's disagreement with Deloitte's professional judgment does not meet that test.

In essence, the plaintiffs concede that Deloitte made a sufficient investigation into WOW's finances but contend that Deloitte's ultimate resolution of the accounting issues regarding those finances was incorrect. That contention is not sufficient to establish scienter. "[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter." *Malone*, 26 F.3d at 479 (quotation omitted). *Accord, e.g., Vosgerichian v. Commodore Int'l*, 832 F.Supp. 909, 915 n. 8 (E.D.Pa.1993) ("The . . . complaint charges that [the accountants] . . . violated GAAP and GAAS, but clearly, even deliberate violations of those guidelines, without more, do not amount to fraud.") (collecting cases).

"[Scienter] requires more than a misapplication of accounting principles. The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *SEC v. Price Waterhouse*, 797 F.Supp. 1217, 1240 (S.D.N.Y.1992) (citations, quotations, and footnote omitted). As a result, Deloitte's evidence indicating that the accounting decisions were reasonable negates the plaintiffs' attempt to establish scienter. *See id.* at 1241 ("[The disputed] items involved complex issues of accounting as to which reasonable accountants could reach different conclusions. Indeed, . . . the Court heard diametrically opposing views from experts as to the reasonableness of [the] accounting

and audit judgments. It follows that no finding of fraud or recklessness can rationally be made in this case."); *Software Toolworks,* 789 F.Supp. at 1504 & n. 30 ("Plaintiffs . . . second guess Deloitte's decision that a 44% reserve was appropriate – this is not enough to infer scienter in this case. . . . Nor are Plaintiffs' expert's conclusory statements sufficient to defeat summary judgment."); *cf. Fine v. American Solar King Corp.,* 919 F.2d 290, 296-98 (5th Cir.1990) (triable issue regarding scienter exists where plaintiffs directly established that accountants *knew* they had violated GAAP by issuing false statements), *cert. dismissed,* ___ U.S. ___, 112 S.Ct. 576, 116 L.Ed.2d 601 (1991).

Rossi's conclusory allegations do not change this analysis. In sum, his declaration consists of self-righteous statements that, because Deloitte did not audit WOW as he would have done, Deloitte must have acted fraudulently. Such evidence is not sufficient. *See WOW,* 814 F.Supp. at 871 n. 15 ("this is not the first time that a district court has awarded summary judgment to an auditor on the scienter issue in the face of a declaration by Rossi"); *Software Toolworks,* 789 F.Supp. at 1504-10 (same).[7]

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[7] The plaintiffs argue that we should be particularly sceptical of Deloitte's conduct in this case because the auditor had become "entangled" with WOW by offering discounts on its fees. This contention is utterly without merit:

> . . . It defies economic reality to suggest that a professional firm which extends a discount or does not bill its full fee for its "learning curve" in order to retain and accommodate a client has compromised its independence merely because it may colloquially

We affirm the district court's conclusion that Deloitte did not act with scienter.

C.

Finally, the plaintiffs argue that the Directors and the Shareholders violated section 10(b) by selling WOW securities with knowledge of undisclosed adverse, material information. A private right of action for insider trading exists under section 10(b) for persons who traded contemporaneously with the insider. *E.g., Neubronner v. Milken*, 6 F.3d 666, 670 (9th Cir.1993). To establish section 10(b) liability, however, the plaintiffs must prove that the insider traders acted with scienter. *E.g., Dirks v. SEC*, 463 U.S. 646, 663 & n. 23, 103 S.Ct. 3255, 3266 & n. 23, 77 L.Ed.2d 911 (1983). The district court exhaustively explained why the plaintiffs had not done so in this case:

> Plaintiffs assert that since these defendants sold some of their shares in WOW prior to

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> refer to that circumstance as an "investment" in the client. Indeed, this argument reflects the [plaintiff]'s general approach to this case, *i.e.*, to seize and grasp any fact to support any argument, however irrational, to justify its claim of fraud. . . .
>
> . . . It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees. The Court therefore declines the [plaintiff]'s invitation to look with a jaundiced eye at each accounting decision made during a complex audit merely because of an accountant's economic motivation in maintaining an ongoing relationship with a client.

Price Waterhouse, 797 F.Supp. at 1242 & n. 60 (citation omitted).

WOW's financial collapse, they must have known of some information, not already known to the market, that signalled WOW's imminent doom. Plaintiffs' "evidence," though, consists of mere speculation and conclusory allegations. . . .

. . . The evidence . . . shows only that the opportunity for insider trading existed. . . . In this case, after years of discovery, Plaintiffs cannot point to any bit of information traded on by these defendants that was not already known to the market. This speaks to the merits of their claims.

. . . "Insider trading in suspicious amounts or at suspicious times is probative of scienter." *Apple Computer*, 886 F.2d at 1117. But in this case, when one considers the amounts traded, Plaintiffs' claims appear fantastic. These defendants sold only a portion of their holdings in WOW. Of course, an insider may not always trade all his shares in the company for which he possesses the inside information; the trader may hold on to a portion of his shares to hedge against the unforeseen or to obscure the insider trading from the SEC. Here, however, Plaintiffs' allegation is essentially that these defendants possessed inside information on WOW's imminent collapse, so one would expect that they would have sold a good proportion of their holdings.

On the contrary, most of these defendants sold only a minuscule fraction of their holdings in WOW, and ended up reaping the same large losses as did Plaintiffs when WOW collapsed. . . .

> In sum, with this evidence, no reasonable jury could find that insider trading had occurred, or that these defendants acted with scienter.

WOW, 814 F.Supp. at 871-72. We agree.

Even if the evidence was sufficient to permit an inference that one or more of the defendants had access to inside information, the defendants' actual trading would conclusively rebut an inference of scienter. Director Margolis, several other partners in WOW Shares Partnership, and shareholder Robinson Interests sold their shares pursuant to a predetermined plan in accordance with SEC Rule 144. Robinson Interests, moreover, "sold its shares because it faced a pressing need to service a huge debt incurred from overinvesting in real estate." *WOW*, 814 F.Supp. at 872 n. 17. Other WOW Shares partners "who supposedly possessed inside information did not sell at all." *Id.* at 872. Director Howenstein "sold only 50,000 shares before WOW's bankruptcy, though he possessed over 970,000" shares at the time of the bankruptcy. *Id.* Shareholder Abercrombie started selling WOW shares (to raise cash for real estate improvements) *after* the announcement of large quarterly losses and, in total, still held onto eighty-six percent of her WOW stock (2,870,000 shares) at the time the corporation filed for bankruptcy.

"[This] pattern of stock trading . . . is insufficient to raise an issue for the jury. . . . Uncontradicted deposition testimony . . . provided credible and wholly innocent explanations for the stock sales, ranging from long-standing programs of periodic divestment, to the need to free cash to meet matured tax liabilities. These unrebutted explanations are sufficient to defeat any inference of bad

faith." *Apple Computer*, 886 F.2d at 1117. *See, e.g., Freeman v. Decio*, 584 F.2d 186, 197 n. 44 (7th Cir.1978) ("inference [of scienter] can be nullified by a showing that sales in question were consistent in timing and amount with a past pattern of sales or that other circumstances might reasonably account for their occurrence").

We therefore affirm the district court's conclusion that the Directors and the Shareholders are not liable for insider trading.[8]

V.

In conclusion, for the reasons stated by the district court in its excellent opinion, we affirm the summary judgment in favor of the defendants on all issues except the section 11 claim against Deloitte. We reverse and remand that claim, however, because the court applied an incorrect test of section 11(e) loss causation. In light of this remand, we also reinstate the plaintiffs' supplemental state-law claims against Deloitte.[9] All defendants other than Deloitte are awarded their costs.

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[8] In light of this conclusion, we need not consider the defendants' argument that, in any event, the plaintiffs cannot bring insider trading claims because they did not trade "contemporaneously" with the insiders. We do note, however, that recent Ninth Circuit authority indicates that the defendants' "contemporaneous trading" argument has significant merit. *See Neubronner*, 6 F.3d at 670 ("insider trading claims under section 10(b) and Rule 10b-5 is confined to persons who traded contemporaneously with the insider . . . [and] contemporaneous trading must be pleaded with particularity") (affirming dismissal of insider trading complaint).

[9] The plaintiffs also brought "controlling person" claims against various defendants. *See* 15 U.S.C. §§ 77o; 78t(a). We

AFFIRMED in part. REVERSED in part. REMANDED for proceedings consistent with this opinion.

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affirm the summary judgment on these claims because, as the district court noted, "[t]here being no primary violation, there can be no secondary violation." *WOW*, 814 F.Supp. at 872. Deloitte's potential section 11 liability does not change this conclusion because the plaintiffs did not allege that any defendant controlled the auditor.

APPENDIX B

In re WORLDS OF WONDER SECURITIES LITIGATION.

This Document Relates to: All Actions.

No. C 87-5491 SC.

United States District Court,
N.D. California.

Jan. 20, 1993.

Order Denying Plaintiffs Motion to Reconsider March 8, 1993.

ORDER RE SUMMARY JUDGMENT

CONTI, District Judge.

I. INTRODUCTION

Plaintiffs are a class of purchasers of stock and debentures issued by Worlds of Wonder, Inc. ("WOW"). Plaintiffs have sued several officers of WOW, two members of WOW's board of directors, WOW's independent auditor, the underwriters of WOW's securities offerings, and several major shareholders of WOW stock. Plaintiffs allege federal claims under Section 11 and Section 12(2) of the Securities Act of 1933, and also Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder. In addition, Plaintiffs allege state law claims of fraud and negligent misrepresentation.

Each defendant now moves for summary judgment. The court addresses these motions together in this Order.

II. BACKGROUND

This case arises out of the demise of Worlds of Wonder, Inc. ("WOW"), a high-technology toy company which sold its products to major toy retailers, mass merchants, and department stores. Within a year of its incorporation, WOW reached the peak of success for the toy industry when its first product, a talking teddy bear, became the nation's best selling toy. Two years later, however, WOW's sales had declined dramatically, and WOW was faced with a serious liquidity crisis. WOW filed for bankruptcy protection within three years of its founding.

WOW was formed in 1985 around a single line of toy products, the World of Teddy Ruxpin, which featured an animated talking teddy bear. Teddy Ruxpin was among the best selling toys in the nation for the Christmas season of 1985. WOW ended its first fiscal year on March 31, 1986 with more than $93 million in net sales.

On June 20, 1986, WOW conducted an initial public offering of common stock (the "IPO"). The IPO was underwritten by a syndicate of investment banks and co-managed by Smith Barney, Harris Upham & Co. ("Smith Barney") and Dean Witter Reynolds, Inc. ("Dean Witter").

The offering materials for the IPO included a prospectus dated June 20, 1986 (the "IPO Prospectus"). The IPO Prospectus contained an extensive discussion of the risks WOW posed to investors,[1] including the fact that WOW's success was entirely based on a single product.

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[1] These risk disclosures are set forth in greater detail at *infra* part IV.B.1.

The IPO Prospectus further cautioned investors that, given the competitive nature of the toy industry, WOW could not ensure that it could repeat its initial success. Also, the IPO Prospectus revealed that WOW's working capital, even considering the proceeds from the IPO, was not necessarily sufficient to last through the end of fiscal 1987 (March, 1987). Nevertheless, the investment community was enthusiastic about WOW. On the day of the IPO, the offering price of $18 per share was driven up to $29 by the close of the day.

Following the IPO, WOW continued to grow rapidly. WOW's second major toy was Lazer Tag, a game involving toy weapons that used infrared technology. Lazer Tag, like Teddy Ruxpin, was wildly successful when it first hit the market. It was the best selling toy for the 1986 Christmas season. Also, Teddy Ruxpin maintained its popularity for the most part during 1986. In Lazer Tag and Teddy Ruxpin, WOW had two of the ten best selling toys for the 1986 Christmas season. At the beginning of 1987, WOW was the toast of the toy industry, having recorded net sales of over $327 million for the previous fiscal year.

WOW's officers hoped to continue WOW's tremendous growth by introducing new lines of animated toys based on the Muppets characters, and by introducing lines of accessories intended to extend the life span of the demand for Teddy Ruxpin and Lazer Tag. To raise the necessary capital, on June 4, 1987 WOW conducted an offering of $92 million worth of convertible debentures

(the "Debentures").[2] The Debenture offering was underwritten solely by Smith Barney.

The offering materials included a prospectus dated June 4, 1987 (the "Debenture Prospectus"). The Debenture Prospectus, much as the IPO Prospectus, contained an extensive discussion of the specific risks inherent in investing in WOW.[3] The Debenture Prospectus revealed facts showing that WOW's cash position was precarious at best. It was obvious to any reasonable investor that WOW would be unable to survive any unanticipated shortfall in its revenues, and this risk was well known to the market. Indeed, the two major rating agencies for securities, Moody's and Standard & Poors, rated the Debentures as below investment grade – that is, junk bonds. Although Smith Barney had initially indicated that it expected the interest rate WOW would bear on the Debentures to be 5.5-6%, the market ultimately demanded a 9% rate.

WOW's fortunes took a drastic turn for the worst shortly after the Debenture Offering. Financial results for the quarter ended June 30, 1987 were below the company's internal projections, even though the company had already predicted a substantial loss for the quarter. WOW's management hoped that the decline in sales was due to the normal seasonality of the toy business, where most sales occur during the Christmas season.

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[2] Debentures are unsecured debt, as opposed to bonds, which are secured by the assets of the issuing company.

[3] These risk disclosures are set forth in greater detail at *infra* part IV.C.1.

The big 1987 Christmas season that WOW had wished for, though, never occurred. WOW's officers blame the stock market crash on October 19, 1987. According to WOW's management, this made retailers cautious about ordering additional products. For whatever reasons, the entire toy industry experienced a severe downturn in late 1987. WOW was especially hurt because its only major products, Lazer Tag and Teddy Ruxpin, were high priced items that were particularly dependent on the Christmas season for sales. A substantial price reduction in WOW's major products in late October 1987, combined with a stepped-up advertising campaign, failed to spur sales to expected levels.

In December, 1987, WOW defaulted on the first interest payment on the Debentures. Faced with a severe liquidity crisis, WOW was unable to make it through the Christmas season as a going concern. WOW filed for bankruptcy on December 21, 1987.

The plaintiffs in this action are a class of purchasers of WOW common stock and Debentures ("Plaintiffs").[4] Plaintiffs assert that they were defrauded, or at least misled, regarding the risky nature of their investment. Plaintiffs allege that several of the various defendants' actions in connection with WOW's securities offerings misled investors, and unduly inflated the market price of WOW's securities. Most notably, Plaintiffs claim that the

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[4] This court certified the class pursuant to Federal Rule of Civil Procedure 23(b)(3) in an Order dated March 23, 1990. The class consists of individuals who purchased WOW common stock or Debentures during the period June 20, 1986 through November 9, 1987.

IPO Prospectus and the Debenture Prospectus contained misleading statements and omitted material information. They also claim that several of the defendants traded WOW stock based on inside information.

Plaintiffs' Third Amended Complaint (the "Complaint") names as defendants several officers of WOW: Angelo M. Pezzani, former President and Chief Operating Officer; Donald D. Kingsboro, WOW's former Chief Executive; and Richard B. Stein, former Executive Vice President and Chief Financial Officer (collectively the "Officer Defendants"). The Complaint also names two directors of WOW as defendants: John B. Howenstein and Barry H. Margolis. Plaintiffs also allege claims against WOW's independent auditor, the public accounting firm of Deloitte Haskins & Sells, now known as Deloitte & Touche ("Deloitte"), and the underwriters of WOW's securities offerings, Smith Barney and Dean Witter (the "Underwriter Defendants"). The Complaint also alleges claims against certain large shareholders of WOW: Josephine E. Abercrombie, an individual; World of Wonder Shares Partnership ("WOW Shares Partnership"); and Robinson Interests, Inc. ("Robinson").

Plaintiffs' Complaint sets forth claims for relief alleging numerous violations of the federal securities laws. Plaintiffs' First Claim for Relief alleges violations of Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78j (b), and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder, 17 C.F.R. § 240.10(b)(5). Plaintiffs' Fifth and Sixth Claims for Relief, respectively, allege violations of Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (a), in connection with the IPO

Prospectus and the Debenture Prospectus. Plaintiffs' Seventh and Eighth Claims for Relief allege violations of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2), in connection with the IPO Prospectus and the Debenture Prospectus, respectively. Plaintiffs' Second and Ninth Claims for Relief state theories of joint and several liability for the alleged substantive violations of the securities laws.

In addition, Plaintiffs' Third and Fourth Claims for Relief allege state law claims of fraud and negligent misrepresentation, respectively.

The case is currently before the court on the various defendants' motions for summary judgment. The court addresses these motions together in this Order.

III. SUMMARY JUDGMENT STANDARD

Summary judgment is proper if, after viewing the evidence in the light most favorable to the non-moving party, there is no genuine issue of material fact and the moving party is entitled to prevail as a matter of law. Fed.R.Civ.P. 56(c); *Hutchinson v. United States*, 838 F.2d 390, 392 (9th Cir.1988). The party moving for summary judgment has the burden of proving the absence of any genuine issue of material fact. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 256, 106 S.Ct. 2505, 2514, 91 L.Ed.2d 202 (1986).

If, however, the moving party demonstrates the absence of any genuine issue of material fact, the burden shifts to the non-moving party to produce evidence sufficient to support a jury verdict in his favor. *Id.* at 255, 106

S.Ct. at 2514. To meet this burden, the non-moving party must go beyond the pleadings and show "by her own affidavits, or by the depositions, answers to interrogatories, or admissions on file" that a genuine issue of material fact exists. *Celotex Corp. v. Catrett*, 477 U.S. 317, 324, 106 S.Ct. 2548, 2553, 91 L.Ed.2d 265 (1986).

IV. PLAINTIFFS' SECTION 11 CLAIMS

Section 11 of the Securities Act of 1933 creates a private remedy for any purchaser of a security if any part of the prospectus "contained an untrue statement of a material fact or omitted to state a material fact . . . necessary to make the statements therein not misleading." 15 U.S.C. § 77k (a). A Section 11 claim can be asserted against every person who signed the prospectus, the issuer's officers and board of directors, the underwriters of the securities offering, and any expert whose profession gives authority to that part of the registration statement prepared by him. *Id.*

Plaintiffs' Fifth and Sixth Claims for Relief allege violations of Section 11 in connection with the IPO Prospectus and the Debenture Prospectus, respectively. Plaintiffs assert these claims against the Officer Defendants, the Underwriter Defendants, directors Howenstein and Margolis, and Deloitte.

A. *The Bespeaks Caution Doctrine and the Duty to Disclose Information in a Prospectus*

1. The "Bespeaks Caution" Doctrine

The Officer Defendants urge this court to adopt the "bespeaks caution" approach to securities fraud claims. The bespeaks caution doctrine holds that when a prospectus contains substantial disclosure of specific risks, statements that express management's optimism about future performance, despite those particular risks, are not misleading as a matter of law. Though this doctrine has not yet been adopted expressly by the Ninth Circuit, the trend in the recent cases heavily favors adopting this approach. In addition, the bespeaks caution doctrine would be dispositive not only of the claims against the Officer Defendants, but also of many of the claims against the other defendants. Thus, a discussion of the bespeaks caution doctrine and its application is necessary.

(a.) Origins of the Bespeaks Caution Doctrine

The bespeaks caution doctrine originated from language in *Polin v. Conductron Corp.*, 552 F.2d 797 (8th Cir.1977), *cert. denied*, 434 U.S. 857, 98 S.Ct. 178, 54 L.Ed.2d 129 (1977). In that case, the plaintiff, a shareholder in Conductron, alleged fraud by Conductron in its annual report. The report stated that Conductron's "results were 'expected' to show improvement, and the Company saw a 'possibility' of a break-even soon." *Id.* at 806 n. 28. The Eighth Circuit Court of Appeals held that "terms thus employed bespeak caution in outlook and fall

far short of the assurances required for a finding of falsity and fraud." *Id.*

The Second Circuit established the bespeaks caution doctrine more firmly in *Luce v. Edelstein*, 802 F.2d 49 (2d Cir.1986). In that case, the plaintiffs, a class of purchasers of shares in a limited partnership, claimed that the Offering Memorandum made certain false and misleading statements about the potential cash and tax benefits of the partnership. The court found that "the Offering Memorandum made it quite clear that its projections of potential cash and tax benefits were 'necessarily speculative in nature' and that 'no assurance [could] be given that these projections [would] be realized.' " *Id.* at 56. The Offering Memorandum further warned that " '[a]ctual results may vary from the predictions and these variations may be material.' " *Id.* The court held that the plaintiffs had failed to state a claim based on these statements, stating "[w]e are not inclined to impose liability on the basis of statements that 'bespeak caution.' " *Id.* The court relied on *Polin* for this proposition.

Since the *Luce* decision, the First, Sixth, and Eighth Circuit Courts of Appeals have adopted the bespeaks caution doctrine. In the First Circuit case of *Romani v. Shearson Lehman Hutton*, the plaintiffs claimed that the defendants fraudulently induced them to invest in a horse breeding farm. 929 F.2d 875 (1st Cir.1991). The plaintiffs, a class of similarly situated investors, alleged "misrepresentations and omissions in the offering materials that falsely inflated the partnership's financial potential." *Id.* at 876. The court found, however, that "the offering materials are replete with statements, some highlighted, emphasizing the high risks associated with [the

partnership] and that '[t]here can be no assurance that the investment objectives of the Partnership will be obtained.' " *Id.* at 879. The court held that "[d]ocuments such as this, which 'clearly bespeak caution,' are not the stuff of which securities fraud claims are made." *Id.* (citing *Luce*, 802 F.2d at 56).

In *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir.1991), the Sixth Circuit addressed a similar claim by a plaintiff class of shareholders. The plaintiffs alleged that certain projections of economic performance by the company's management artificially inflated the price of plaintiffs' shares. *Id.* at 1039. The court found, however, that these projections were "also accompanied by cautionary language." *Id.* at 1040. The court affirmed the district court's dismissal of the case, holding that "economic projections are not actionable if they bespeak caution." *Id.*

The Eighth Circuit reinforced its position on the bespeaks caution doctrine in *Moorhead v. Merrill Lynch*, 949 F.2d 243 (8th Cir.1991). In *Moorhead*, the plaintiffs were purchasers of bonds used to finance a residential retirement center. The retirement center later filed for bankruptcy under Chapter 11, and under the reorganization plan the bondholders only received 60 cents per dollar owed. *Id.* at 244-45. The plaintiffs alleged a claim for securities fraud against Merrill Lynch based upon a feasibility study, prepared by Merrill Lynch and included with the offering memorandum, that was generally favorable on the future economic viability of the retirement center. *Id.* The district court had found that "the feasibility study contained a number of risk statements, detailed cautionary language and disclosures about the underlying economic assumptions, any of which could

have affected the retirement center's ability to pay back the bonds." *Id.* at 245. The court of appeals affirmed the district court's entry of summary judgment for the defendants. *Id.* Though the court did not use the phrase "bespeaks caution," it held that "plaintiffs could not base a federal securities law claim on any misrepresentation or omission in the feasibility study which was addressed by the repeated, specific warnings of significant risk factors and the disclosure of underlying factual assumptions also contained therein." *Id.*

The Ninth Circuit has not yet explicitly adopted the bespeaks caution doctrine. However, the bespeaks caution doctrine is consistent with the Ninth Circuits' approach to securities fraud claims. In *In re Convergent Technologies Securities Litig.*, the plaintiffs, a class of purchasers of stock, alleged that defendants misled investors by concealing information on the company's cost and production problems with one of its product lines. 948 F.2d 507, 515 (9th Cir.1991). The court found, however, that the company's "[p]rospectus virtually overflows with Convergent's repeated emphasis of significant risk factors." *Id.* The prospectus included the following disclosures:

> There can be no assurance that the company will successfully complete the development of its new products or that it will be successful in manufacturing . . . or marketing the products in the face of intense competition;
>
> . . . .
>
> While the Company believes that the technical risks in the development of [the product line] are well controlled, the product cost objectives

> are very aggressive and there is no assurance they can be achieved.

Id. In affirming the district court's entry of summary judgment for the defendants, the court stated that "[n]o investor, in the face of these substantive disclosures, could reasonably conclude that Convergent had surmounted all obstacles in [the product's] path." *Id.* at 516. The court held that the prospectus was not misleading on these issues as a matter of law. *Id.* Thus, this case is consistent with the bespeaks caution approach.[5]

(b.) Application of the Bespeaks Caution Doctrine

The parties disagree, predictably, on the application of the bespeaks caution doctrine to the facts of this case.

The Officer Defendants argue that if the court finds substantial risk disclosure in the IPO Prospectus and the Debenture Prospectus, then the defendants are completely immunized from liability under Section 11. This would be an overextension of the doctrine. Such an overbroad application of the doctrine would "encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language." *Trump Casino,* 793 F.Supp. at 554. To prevent this from occurring, "the bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future

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[5] One court even has read *Convergent Technologies* as adopting the bespeaks caution doctrine as the law in the Ninth Circuit. *See In re Donald Trump Casino Securities Litig.*, 793 F.Supp. 543, 551-52 (D.N.J.1992).

projections, estimates or forecasts in a prospectus." *Id.* By contrast, blanket warnings that securities "involve a high degree of risk" have been held insufficient to ward against a federal securities fraud claim. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir.1981), *aff'd in relevant part and rev'd in part on other grounds*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).

In addition, the bespeaks caution doctrine does not apply to immunize false statements if the defendants knew the statements were false when made. "To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit." *Huddleston*, 640 F.2d at 536.

Plaintiffs, for their part, argue that the bespeaks caution doctrine is no substitute for a fact-specific inquiry into each statement they allege to be misleading. Plaintiffs seem to be arguing that each statement they present to the court must be analyzed, with the benefit of hindsight, to determine whether it was misleading at the time it was made. According to Plaintiffs, the "bespeaks caution" cases discussed above do not obviate the need for this type of inquiry.

Plaintiffs' reading of these cases misses the whole point of the bespeaks caution doctrine. The doctrine holds that economic projections, estimates of future performance, and similar optimistic statements[6] in a prospectus are not actionable when precise cautionary

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[6] "Professional investors, and most amateur investors as well, know how to devalue the optimism of corporate executives, who have a personal stake in the future success of the

language elsewhere in the document adequately discloses the risks involved. It does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous assumptions when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based. *See Trump Casino,* 793 F.Supp. at 553-54. This aspect of the bespeaks caution doctrine represents an evolution in the judicial analysis of whether a particular statement was misleading.

Accordingly, this court adopts the following formulation of the bespeaks caution doctrine. Estimates or forecasts of future performance in a prospectus are not actionable if the prospectus contains conspicuous language that bespeaks caution as to actual results. Furthermore, the cautionary language must specifically disclose the nature and extent of the risks involved.

In the context of a summary judgment motion, this approach answers in a dispositive way a claim that a particular statement is misleading. The doctrine holds that where a prospectus contains adequate cautionary language disclosing specific risks, no reasonable inference can be drawn that a statement regarding those risks was misleading. This is the analysis this court will apply to Plaintiffs' allegations that particular statements in the IPO Prospectus or the Debenture Prospectus were misleading.

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company." *In re Verifone Securities Litig.*, 784 F.Supp. 1471, 1481 (N.D.Cal.1992) (citations omitted).

2. *The Duty to Disclose Information in a Prospectus*

Plaintiffs also base their Section 11 claims on the defendants' alleged failure to disclose certain risks in the prospectuses. If the documents are completely silent on a matter, the "bespeaks caution" doctrine is inapplicable. One cannot simultaneously bespeak caution on a subject and not address it.

"The securities laws do not require an issuer of stock to disclose every bit of information that has some bearing on the issuer's future earnings." *In re Verifone Securities Litig.*, 784 F.Supp. 1471, 1480 (N.D.Cal.1992). In a fraud on the market case, "[s]ilence, absent a duty to disclose, is not misleading." *Basic, Inc. v. Levison*, 485 U.S. 224, 239 n. 17, 108 S.Ct. 978, 987 n. 17, 99 L.Ed.2d 194 (1988). For Plaintiffs to prevail on a claim that the prospectuses omitted information necessary to prevent a fraud on the market, they must show, "as a threshold matter, that the information was of a kind which the defendants had a legally cognizable duty to disclose." *Id.*

The Supreme Court has set forth the standard for courts to apply in determining whether nondisclosure violates the securities laws. In *Basic, Inc. v. Levison*, the Court held that for nondisclosure to be actionable "there must be a *substantial* likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having *significantly* altered the 'total mix' of information made available." 485 U.S. at 231-32, 108 S.Ct.

at 983 (emphasis added).[7] The Court "was careful not to set too low a standard" for disclosure. *Id.* at 231, 108 S.Ct. at 983. The Court expressed concern that too low a standard would "lead management 'simply to bury the shareholders in an avalanche of trivial information – a result hardly conducive to informed decisionmaking.' " *Id.* (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976)).

Thus, in evaluating Plaintiffs' allegations that the prospectuses were misleading for failing to disclose certain risks, the court will inquire whether a hypothetical reasonable investor would have felt the information necessary in deciding whether to invest in WOW.

Having set forth the analytical framework it will apply to this case, the court now turns to Plaintiffs' factual allegations based on the IPO Prospectus and the Debenture Prospectus. As noted above, the allegedly misleading statements or omissions offered by Plaintiffs cannot be judged standing alone. The statements that Plaintiffs claim are misleading must be evaluated in light of the risk factor disclosure set forth elsewhere in the document. Furthermore, the "bespeaks caution" doctrine precludes any inference that a statement which directly relates to any adequately disclosed risk factor is misleading. As to omissions alleged by Plaintiffs, the inquiry for this court is whether the particular omissions were of facts material to WOW's financial well-being at the time

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[7] The Court in *Basic, Inc.* was faced with only a Rule 10b-5 claim, but the lower courts have applied its standard for disclosure in Section 11 cases as well. *See, e.g., In re Verifone*, 784 F.Supp. at 1480.

of the prospectus, so as to obligate WOW to disclose them in the prospectus.

B. *The IPO Prospectus*

1. Risk Disclosure

The IPO Prospectus contains a section titled "Risk Factors." This section consists of three single-spaced pages disclosing WOW's specific business risks, including the following cautionary language:

> **Dependence on Single Product Line; New Product Introductions.** To date, the Company has marketed from a single product line, the World of Teddy Ruxpin. The product life cycle of a toy line is relatively short. Successful new products and new product lines may therefore be crucial to the success of the Company's business. . . . The Company has only limited experience in product introductions, and product line expansion will place great demands on management and other Company resources. If the Teddy Ruxpin product line loses market acceptance, or if new product introductions are unsuccessful, the Company's business would be affected adversely.
>
> . . . .
>
> **Competition.** The toy industry is highly competitive. . . . The relatively low barriers to entry into the toy industry also permit new competitors to easily enter the industry. The Company believes it has enjoyed limited competition to its Teddy Ruxpin product line. Due to the success of Teddy Ruxpin, however, the Company anticipates other companies will introduce talking toy

products that will compete with Teddy Ruxpin and other new products announced by the Company. Such entrants might force price reductions or cause the Company to lose market share, which events may adversely affect the Company.

. . . .

Seasonality of Quarterly Results; Loss for the First Quarter of Fiscal 1987. Sales of toys are highly seasonal, with a majority of retail sales taking place during the Christmas season. Although indications of interest are provided by retailers early in the year, orders are generally cancellable without penalty. The seasonality of sales may cause operating results to vary significantly from quarter to quarter. The company anticipates that net sales for the quarter ending June 30, 1986 will be less than those for the prior quarter and, as a result, the Company expects to report a loss for the quarter. . . . There can be no assurance that the Company can maintain sufficient flexibility with respect to its working capital needs, manufacturing capacity and supplies of raw materials, tools and components to be able to minimize the adverse effects of an unanticipated shortfall in demand.

Capital Requirements. The Company's cash flow from operations, existing bank lines of credit and the proceeds of this offering may not be sufficient to provide the working capital required beyond the end of fiscal 1987. Thereafter, the Company may have to obtain additional working capital from expanded bank borrowings or through additional debt or equity financings. If the Company is unable to obtain adequate working capital from these sources on

> acceptable terms, its operations would be adversely affected. A significant portion of the Company's working capital is composed of accounts receivable. The Company believes the toy industry is characterized by accounts receivable on extended terms, especially in the summer months, and as a result a material portion of the Company's accounts receivable are aged longer than 90 days. The Company's liquidity may be adversely affected by excessive aging of its accounts receivable.

Significantly, the "Risk Factors" section of the IPO Prospectus is not buried beneath other, more optimistic language. On the contrary, it appears as the first major subsection of the document, directly after the Prospectus summary. Moreover, the front page of the IPO Prospectus contains the statement, in boldface type, that "Prospective investors should carefully consider the factors set forth under 'Risk Factors.' "

2. *Plaintiffs' Allegations and Evidence*

In their opposition to defendants' motions, Plaintiffs raise a number of arguments to support their claim that certain statements in, or omissions from, the IPO Prospectus were misleading. The court addresses each of these arguments below.[8]

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[8] The court addresses only those contentions raised by Plaintiffs in their opposition papers. Plaintiffs have made numerous other allegations of misleading statements or omissions in their Complaint; they have thrown in the proverbial kitchen sink. But because Plaintiffs do not offer any evidence to support these allegations, these allegations present no genuine

(a.) Product Reliability and Defects

The IPO Prospectus disclosed that initial versions of Teddy Ruxpin were being returned by the consumers at a level higher than 10%. According to the IPO Prospectus, 10% was the expected return rate for toys similar to Teddy Ruxpin. However, the IPO Prospectus predicts that "product returns for [this] existing product line will be favorably affected by recent product modifications." Plaintiffs argue that this latter statement is false or misleading because WOW allegedly was already experiencing a substantially higher return rate at the time of the IPO.

Plaintiffs' evidence for this contention is flimsy at best. Plaintiffs present the testimony of some of WOW's customers that the return rate for Teddy Ruxpin at about the time of the IPO was over 20%. But this does not contradict the statement in the IPO Prospectus. The Prospectus predicts only that the return rate would decrease in the future as the modifications were implemented. Plaintiffs have no evidence that the return rate for Teddy Ruxpin *after* the modifications were made was higher than the rate before the modifications.

More importantly, WOW was not under any duty to disclose such information at all. There is no evidence that the return rate for Teddy Ruxpin had any effect upon WOW's sales of the product to retailers. Indeed, Teddy Ruxpin is still selling relatively well as of this date.[9]

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issues of fact, and are not considered by the court in deciding these motions.

[9] The Teddy Ruxpin line of products was sold to Hasbro.

Disclosure of the actual return rate was not required to make the statement in the Prospectus not misleading, unless the return rate posed a material risk to investors at the time of the IPO. Plaintiffs have shown no evidence that this was the case.

(b.) Poor Product Demand

Plaintiffs claim that the IPO Prospectus falsely expressed optimism about the demand for the Teddy Ruxpin line of products. They base this allegation on the mere fact that WOW was introducing new accessory items intended to extend the life cycle of the Teddy Ruxpin line. The IPO Prospectus states that "[t]he Company believes that the marketing of these related items . . . will help extend the life cycle of the product line."

This statement, however, does not constitute management's assurance that demand for the Teddy Ruxpin line would remain high. Even if it did, the IPO Prospectus adequately bespoke caution on the risks involved in investing in a company with only a single product line. Thus, any statement relating to the demand for Teddy Ruxpin is not misleading as a matter of law.

(c.) Inadequate Internal Controls

Plaintiffs contend that WOW's system of internal accounting controls was inadequate at the time of the IPO. They argue that the IPO Prospectus' silence on this matter was misleading. There is no evidence, however,

that WOW's system of internal controls presented a substantial business risk to investors at the time of the IPO. On the contrary, WOW had retained Deloitte to install an entirely new system shortly before the IPO.

Plaintiffs point to several documents dated after the IPO, in which certain employees of WOW indicated that the company's rapid growth made necessary further improvement of the internal control systems. These documents, however, are not relevant to the issue of whether, at the time of the IPO, WOW had a duty to disclose any information about the alleged inadequacy of its internal controls. The company need only disclose those risks material to an investor's decision to purchase the securities. WOW did not have a duty to disclose every possible risk, no matter how slight, that may have arisen in the future.

(d.) Extended Payment Sales

The IPO Prospectus states that "[t]he Company does not factor its accounts receivable and ships all of its products on terms requiring relatively prompt payment." Plaintiffs argue that this statement was false or misleading. They base this allegation solely upon the fact that in early 1986, WOW gave one customer extended payment terms on one order. Plaintiffs present evidence showing that in early 1986, defendant Kingsboro personally allowed Toys R Us to pay in 90 days or December 10, 1986, whichever was later, on an order of more than $3,700,000.

It is impossible for this court to hold that this one transaction makes the statement in the IPO Prospectus a violation of the securities laws. A few months may be considered "relatively prompt" among businesses when the amount to be paid is $3,700,000. Moreover, Toys R Us was the nation's largest toy retailer, as well as WOW's largest customer, so it is unlikely that WOW even could have bargained for better terms. Investors more likely would have felt misled by WOW's management if WOW had failed to enter this transaction.

In addition, Toys R Us paid in full in late 1986, and there is no evidence that this payment was ever in doubt. Thus, this transaction never posed a risk to WOW's investors, so WOW was not obligated to disclose its particulars.

(e.) Guaranteed Sales

Plaintiffs contend that the IPO Prospectus failed to disclose that WOW engaged in "guaranteed sales," that is, allowing its customers to return goods for a full credit or refund. The testimony of WOW's officers shows that, from time to time, WOW attempted to reach mutually acceptable accommodations with customers who had problems with unsold inventory of WOW's products. WOW on occasion would allow the unsatisfied customer to return the product in exchange for another product on a dollar-for-dollar basis.

Just because some of WOW's customers were allowed a refund does not mean that, at the time of the IPO, WOW had a practice of offering guaranteed sales to

all its customers. Giving an unsatisfied customer a refund is a normal business method of dealing with an unsatisfied customer. It is not a violation of the securities laws for WOW to fail to disclose such an obvious practice to potential investors.

Unless these alleged guaranteed sales were a substantial threat to WOW's revenues at the time of the IPO, WOW was under no duty to disclose them in the IPO Prospectus. Plaintiffs have no evidence that this was the case, so this omission cannot be said to have misled Plaintiffs.

(f.) Accounts Receivable

Plaintiffs allege that the IPO Prospectus was false and misleading regarding WOW's accounts receivable. Plaintiffs claim that WOW's accounts receivable were severely inflated at the time of the IPO. Plaintiffs argue that the fact that WOW was forced to write-off $3,000,000 of these accounts shortly after the IPO is evidence that the IPO Prospectus was misleading on this issue.

The IPO Prospectus, however, specifically warned that "a material portion" of WOW's accounts were over 90 days old, and that "excessive aging" of these accounts would adversely affect WOW's liquidity. Any reasonable investor was able to interpret "excessive aging" as meaning inability to collect payment, forcing WOW to take a write-off. In short, the IPO Prospectus adequately bespoke caution on the risks concerning WOW's accounts receivable.

(g.) WOW's Liquidity

Plaintiffs claim that the IPO Prospectus made statements about WOW's liquidity that were false and misleading. Specifically, they claim that WOW had less cash on hand than it anticipated. They also argue that WOW misled investors by projecting that its working capital "will be sufficient to meet the Company's short-term cash requirements through the end of fiscal 1987."

These are exactly the types of statements to which the bespeaks caution analysis applies. The "Risk Factors" section of the IPO Prospectus contained numerous statements that very nearly begged investors to take notice of WOW's serious liquidity problems. Not only did the IPO Prospectus disclose that WOW was using bank credit lines for its working capital, it disclosed the fact that WOW possibly would soon have to seek additional lines of credit or sell additional equity to meet its future capital requirements. Any investor in WOW assumed these risks. In the face of this cautionary language, Plaintiffs cannot claim to be misled by the company's prediction that it would continue to be liquid.

(h.) Summary

In sum, the court holds that the IPO Prospectus does not contain any false or misleading statements or omit any material risks that create liability under Section 11. Viewing the document as a whole, it clearly bespoke caution on the specific risk factors involved in investing in WOW. The alleged misrepresentations offered by Plaintiffs are trivial in nature compared to the extent of

the disclosure of material risks found in the document. No reasonable jury could find that any material aspect of the IPO Prospectus was false or misleading. Each defendant is entitled to summary judgment on Plaintiffs' claims based on the IPO Prospectus.

C. *The Debenture Prospectus*

1. *Risk Disclosure*

The Debenture Prospectus, much as the IPO Prospectus, contained a section under the heading of "Risk Factors." This section contained detailed disclosures of the myriad risks involved in investing in WOW, that are substantially identical to the factors listed in the IPO Prospectus, *supra* IV.B.1. In addition, the Debenture Prospectus made the following disclosures:

> **Competition.** Lazer Tag . . . [has] faced more immediate and significant competition than that faced by the Teddy Ruxpin product line in fiscal 1986.
>
> **Capital Requirements.** The Company's existing bank lines of credit and import financing line expire September 30, 1987 and December 31, 1987, respectively. To meet seasonal working capital requirements, the Company has borrowed, and expects to continue to borrow, substantial amounts under these lines, both of which it expects to replace or extend prior to expiration. The Company anticipates that the proceeds of this offering, together with cash flow from operations, existing lines of credit and new bank credit facilities currently being negotiated, will provide sufficient funds to meet

> the Company's capital needs through March 31, 1988. However, if the Company is unable to obtain adequate capital from this offering and such new bank credit facilities on acceptable terms, its operations would be adversely affected. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

This latter section to which the potential investor is referred makes the following further disclosure:

> **Liquidity and Capital Resources**
>
> Since its inception, the Company's internally generated cash flow has not been sufficient to finance accounts receivable, inventory and capital equipment needs, as well as support its growth. The Company has met its capital requirements to date primarily through borrowings under bank lines of credit, the private and public sale of equity securities and borrowings under subordinated notes payable to shareholders.
>
> . . . . At June 3, 1987, the Company had outstanding borrowings of approximately $80 million, representing the maximum amounts available under the borrowing limits of its bank line of credit.
>
> In addition to the bank line of credit, the Company recently negotiated a $35 million unsecured import financing line which expires on December 31, 1987. As of June 3, 1987, the Company had standby letters of credit of approximately $32 million outstanding under this line.

The "Risk Factors" section also included cautionary statements regarding WOW's internal controls:

> **Systems and Control Procedures Requirements.** The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind its growth. While the Company continues to upgrade its systems, procedures and controls to meet the demands of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with growth.

2. *The Market's Knowledge of WOW's Business Risks*

There is substantial evidence that by the time of the Debenture offering, WOW's financial difficulties were widely known to the market. Plaintiffs are relying on a fraud on the market theory in this case. Thus, in addition to overcoming the bespeaks caution doctrine, Plaintiffs must show that a particular statement or omission made the Prospectus misleading in the light of all the information known to the market. *See Convergent Technologies*, 948 F.2d at 512.

Two prominent rating agencies, Moody's and Standard and Poor's, rated the debentures as "below investment grade" securities. Moody's rated the bonds B3, their lowest possible B rating. Moody's states that "[b]onds which are rated B generally lack the characteristics of a desirable investment. Assurance of interest and principal

payments over any long period of time may be small." Standard and Poor's rated the bonds B, which they define as:

> on balance, predominately speculative with respect to the issuer's capacity to pay interest and repay principal in accordance with the terms of the obligation. . . . While such bonds will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.

In other words, the major rating agencies classified these debentures as "junk bonds." That this fact was widely disseminated throughout the market is reflected by the 9% interest rate for the debentures, which was substantially higher than the market rate for lower risk securities.

Since WOW was widely considered in the marketplace to be a risky investment, Plaintiffs' allegations that statements in or omissions from the Debenture Prospectus were misleading deserve especially careful scrutiny by this court.

3. *Plaintiffs' Allegations and Evidence*

(a.) Alleged Errors in the Financial Statements

Plaintiffs allege numerous errors in the financial statements for 1987,[10] included in the back pages of the

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[10] Plaintiffs allege that there were errors in the 1986 financial statements as well, but they have produced no specific evidence on this issue. Accordingly, the court holds that there

Debenture Prospectus. These financial statements were prepared and certified by Deloitte. Plaintiffs contend that the financial statements are erroneous because Deloitte improperly recognized revenue on a number of WOW's transactions.

Even if this were the case, though, every defendant except Deloitte is entitled by statute to rely on Deloitte's expertise on accounting issues. Section 11(b)(3)(C) provides a defense to liability under Section 11 for statements certified by an expert where the defendant "had no reasonable grounds to believe and did not believe . . . that the statements therein were untrue." 15 U.S.C. § 77k(b)(3)(C). Here, Plaintiffs have admitted that WOW's management made full disclosure to Deloitte of all relevant information regarding the questioned transactions. It was Deloitte alone that made the decision to recognize the revenue.

Also, the issues are enormously complex on the question of whether Deloitte's recognition of revenues was in accordance with the standards of the accounting profession. The parties have generated well over 100 pages of conflicting expert testimony on these issues alone. It is absurd in these circumstances for Plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistake by Deloitte. Therefore, even if there are errors in the financial statements,

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are no errors in the 1986 financial statements in either the Debenture Prospectus or the IPO Prospectus.

no defendant except Deloitte can be liable under Section 11 on that basis.[11]

(b.) Price Protection

Plaintiffs argue that the Debenture Prospectus was misleading because it did not disclose that WOW would offer "price protection" to its customers. According to Plaintiffs, WOW had a practice of crediting a customer's account if WOW dropped the price after making a sale to that customer. Plaintiffs claim that WOW was forced to take a write-down of $93 million in 1987, after the debenture offering, due to price protection.

The evidence shows, however, that WOW did not engage in any price protection prior to October, 1987, when it was forced to reduce the prices for its major product lines. There is no evidence that, at the time of the Debenture offering, WOW's management could have foreseen that WOW would have to reduce its prices to such an extent. Thus, the alleged practice of price protection did not pose a foreseeable risk to WOW's investors at the time of the debenture offering, so WOW had no duty to disclose it.

(c.) Alleged Collapse in Sales

The parties do not dispute that WOW's sales of its major product lines, Lazer Tag in particular, decreased dramatically in late 1987. Plaintiffs argue, though, that

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[11] The court discusses Deloitte's liability for the financial statements separately. *See infra* part IV.C.4.

this decrease was already occurring at the time of the Debenture offering, and that this fact should have been disclosed in the Debenture Prospectus.

Plaintiffs contend that the Debenture Prospectus should have disclosed that WOW's sales of Lazer Tag for April and May of 1987 were below plan. However, this "plan" is not material. A company has no duty to disclose its internal projections. *Convergent Technologies*, 948 F.2d at 516. The only question for the court is whether, at the time of the Debenture offering, Lazer Tag sales were declining so dramatically that WOW was required to disclose it in the Debenture Prospectus.

The Officer Defendants have submitted testimony that they believed the decline in Lazer Tag sales to be due to the normal seasonality of toy sales, which was adequately disclosed in the Debenture Prospectus. The Officer Defendants also offer testimony that they believed sales of Lazer Tag would increase by the Christmas season, which was reasonable given that Lazer Tag was a best selling toy during the prior Christmas season.

Plaintiffs submit no admissible evidence to show that WOW's sales had decreased so dramatically at the time of the Debenture offering that WOW's management could have known about, and thus would have had a duty to disclose, the impending collapse of Lazer Tag sales.[12]

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[12] Plaintiffs submit the declaration of John G. Forsythe, WOW's Credit and Collections Manager. Forsythe testifies that based on his conversations with WOW's customers, he knew that Lazer Tag sales were very poor. However, Forsythe had no responsibility for WOW's sales, so he has no personal knowledge of this fact and could not testify to it at trial. If he were [sic]

Plaintiffs cannot use the benefit of 20-20 hindsight to turn management's business judgment into securities fraud.

(d.) Internal Controls

Plaintiffs argue that the Debenture Prospectus was misleading for failing to disclose that WOW's internal control systems were facing serious problems. Plaintiffs ignore the fact the Prospectus included an express disclaimer that "there can be no assurances" that WOW's existing internal controls would continue to be adequate given the rapid pace at which the company was growing. The Prospectus made no predictions to the contrary. Thus, the Prospectus adequately bespoke caution regarding this potential risk to WOW's investors. As a matter of law, Plaintiffs cannot have been misled.

(e.) Alleged Misstatement Concerning WOW's Continued Liquidity

Plaintiffs claim that WOW's prediction that it could meet its capital needs until the end of March, 1988 was misleading, given the fact that WOW filed for bankruptcy in December, 1987. However, the disclosures in the Debenture Prospectus cited by the court, *supra* IV.C.1.,

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testify to the fact that various retailers told him sales were poor, it would be inadmissible hearsay. Thus, none of Forsythe's testimony about Lazer Tag sales would be admissible at trial, and it is not considered by the court in deciding these summary judgment motions.

clearly bespoke caution on the serious risks WOW's liquidity crisis posed to investors. The Debenture Prospectus disclosed that WOW's existing credit lines were extended nearly to the limit, that WOW's receivables had never been sufficient to meet WOW's capital requirements, and that an unforseen decline in demand would seriously affect the company. Plaintiffs are not entitled to an inference that they were misled in the face of these disclosures. Indeed, if courts were to allow plaintiffs in securities fraud cases to survive summary judgment in the face of disclosures this detailed and specific, there would be no point for companies to disclose risks at all. It is not the function of the securities laws to provide investors with insurance against disclosed risks.

(f.) Summary

To summarize, none of the defendants, with the possible exception of Deloitte, can be held liable under Section 11 for the Debenture Prospectus. Putting aside the issue of alleged errors in the 1987 financial statements, this court holds that there are no statements in, or omissions from, the Debenture Prospectus that would give rise to an inference that any part of the document was false or misleading. Summary judgment therefore is appropriate in favor of all defendants except Deloitte on this portion of Plaintiffs' claim.

4. Deloitte's Section 11 Liability for Alleged Errors in the 1987 Financial Statements

Plaintiffs allege that Deloitte erroneously recognized revenues on certain of WOW's significant transactions in fiscal 1987. According to Plaintiffs, this makes false or misleading the 1987 financial statements included in the Debenture Prospectus, which were certified by Deloitte.

Deloitte does not concede that it made any accounting errors in recognizing revenue on the questioned transactions. As mentioned above, this issue is the subject of an extensive battle of experts between Deloitte's accountants and Plaintiffs' expert witness. However, Deloitte alternatively seeks summary judgment on Plaintiffs' Section 11 claim based on two affirmative defenses. First, Deloitte asserts that it exercised "due diligence" in investigating the questioned transactions, so it is not liable even if its recognition of revenue was erroneous. Second, Deloitte contends that it is not liable because Plaintiffs' losses were not caused by its alleged misstatements.

As is set forth below, this court believes that Deloitte's "loss causation" defense entitles it to summary judgment. Therefore, the court does not reach the issues of whether the financial statements are erroneous or whether Deloitte is entitled to a due diligence defense.

Damages for a Section 11 violation are measured by the difference between the amount paid for the security and its price at either the time it was sold or the date the Section 11 claim was filed. *See* 15 U.S.C. § 77k (e). Section 11(e), however, provides that:

> [I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is being asserted, not being true . . . such portion or all of such damages shall not be recoverable.

Id. The defendant has the burden of proof on this defense. *Id.* Though it has been recognized by courts as a "heavy burden," it is not insurmountable, and courts have awarded summary judgment to the defendant in appropriate cases. *See In re Fortune Systems Securities Litigation,* 680 F.Supp. 1360, 1364-65 (N.D.Cal.1987).

This is such a case. It is obvious to any investor that WOW's securities declined in value because the company was barely liquid and faced declining sales for its products, not because its financial statements may have been in error. Plaintiffs have absolutely no evidence to show that any part of the Debentures' decline in value was caused by Deloitte's alleged accounting errors. There was no disclosure of these errors (if indeed there were any errors) to the public at any time before this lawsuit was initiated. Since the marketplace never knew of any alleged accounting errors, the alleged errors cannot be said to have had any effect on the Debentures' market value.

Plaintiffs try to escape this inevitable conclusion by arguing that they purchased the debentures at an artificially high price because the market was misinformed by the erroneous financial statements. Thus, Plaintiffs contend, they have sustained damage caused by Deloitte's alleged errors. This argument, though true in

theory, mistakes the relevance of transaction causation, as opposed to loss causation, in Section 11 claims. Transaction causation is inferred from a showing either that the plaintiffs would not have purchased the security but for defendant's misrepresentation, or that they would have purchased it at a lower price. Transaction causation is relevant to claims under other securities laws, in particular Rule 10b-5.

Congress, however, expressly chose a different measure of damages for Section 11 violations. Damages for a Section 11 violation are simply the difference between the price at which the plaintiff purchased the security and the price on the day it was sold. 15 U.S.C. § 77k (e). Transaction causation is plainly irrelevant under this statutory formula.

Moreover, it is clear that the defense provided for in Section 11(e) addresses loss causation and not transaction causation. As the court in *Fortune Systems* held in applying Section 11(e), "[w]hen a portion of the plaintiff's loss is due to an independent intervening cause, such as a decline in the stock market . . . the defendant cannot be held liable for that portion of the plaintiff's loss." 680 F.Supp. at 1365 (quotations omitted). Congress simply did not intend that those who violate Section 11 must insure investors against all possible business risks. *See id.*

Absent any showing of fraudulent intent, it would be extremely unjust to subject a defendant such as Deloitte to full liability for the collapse of a business merely because it may have made some accounting mistakes. Thus, for the above reasons, summary judgment is granted in favor of Deloitte on its loss causation defense.

Deloitte is not liable under Section 11, as a matter of law, for any errors in the 1987 financial statements.

V. PLAINTIFFS' SECTION 12(2) CLAIMS

Plaintiffs' Seventh and Eighth Claims for Relief allege that the Underwriter Defendants violated Section 12(2) of the Securities Act of 1933. Section 12(2) provides that "[a]ny person who offers or sells a security . . . by the means of a prospectus . . . which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . shall be liable to the person purchasing such security." 15 U.S.C. § 77*l*(2).

The analysis this court applied to Plaintiffs' Section 11 claims, *supra* part IV., applies equally to Plaintiffs' claims under Section 12(2). This court repeats its holding that there are no misleading statements in or material omissions from the prospectuses, aside from possible errors in the 1987 financial statements prepared by Deloitte in the Debenture Prospectus.[13]

Regarding the alleged errors in the 1987 financial statements, only Smith Barney is named as a defendant in

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[13] The court emphasizes again that it is far from certain that there are any errors in the financial statements prepared by Deloitte. The court simply is conserving judicial resources by assuming *arguendo* that the statements are in error, because summary judgment for defendants is clearly appropriate on other grounds.

Plaintiffs Section 12(2) claim on the Debenture Prospectus. Section 12(2) provides a defense for a defendant who proves that "he did not know, and in the exercise of reasonable care could not have known" of the alleged error. *Id.* The financial statements, as mentioned above, were "expertised" by Deloitte, and Smith Barney had no duty to independently repeat the investigation done by Deloitte. Even so, as part of Smith Barney's "due diligence" inquiry, Smith Barney specifically sought and received assurances from Deloitte on the facts that supported Deloitte's decision to recognize revenue on the questioned transactions. Thus, Smith Barney clearly exercised reasonable care, and it did not have any reason to know that there were any errors in the financial statements.

For the above reasons, the Underwriter Defendants are entitled to summary judgment on Plaintiffs' Section 12(2) claims.

VI. PLAINTIFFS' RULE 10b-5 CLAIMS

Plaintiffs allege claims against all defendants for violations of Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder. Section 10(b) provides in relevant part that "it shall be unlawful for any person . . . to use or employ, in connection with the purchase of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j (b). Securities and Exchange Commission Rule 10b-5, which implements Section 10(b), provides:

> It shall be unlawful for any person . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10(b)(5).

In addition, the Supreme Court has held that for a defendant to be liable under Rule 10b-5, there must be a showing of scienter, defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 & n. 12, 96 S.Ct. 1375, 1382 & n. 12, 47 L.Ed.2d 668 (1976). The Ninth Circuit has held that scienter can be proved by a showing of recklessness on the part of the defendant. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir.1990), *cert. denied*, ___ U.S. ___, 111 S.Ct. 1621, 113 L.Ed.2d 719 (1991). For the purposes of Rule 10b-5, reckless conduct is defined as conduct

> involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Id. at 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.1977), *cert. denied*, 434 U.S. 875, 98 S.Ct. 224, 54 L.Ed.2d 155 (1977)).

It is beyond dispute that summary judgment can be granted on the issue of scienter in an appropriate case. *In re Apple Computer Securities Litig.*, 886 F.2d 1109, 1113 (9th Cir.1989), *cert. denied*, 496 U.S. 943, 110 S.Ct. 3229, 110 L.Ed.2d 676 (1990). Plaintiffs must offer more than conclusory allegations, and if the defendants present evidence establishing a lack of scienter, Plaintiffs must produce some affirmative evidence to avoid summary judgment. *See Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434, 1436 (9th Cir.1984). Furthermore, where the evidence presents a pattern of conduct inconsistent with scienter, the non-movant bears a heavy burden in defeating summary judgment with inferences drawn from circumstantial evidence. *See Apple Computer*, 886 F.2d at 1118 (no inference of scienter where "overall pattern of conduct" inconsistent with bad faith); *see also In re Software Toolworks, Inc. Securities Litig.*, 789 F.Supp. 1489, 1498-1500 (N.D.Cal.1992) (same).

Plaintiffs base their claims under Rule 10b-5 primarily on the alleged misstatements or omissions in their prospectuses that the court addressed in part IV, *supra*. The analysis this court applied to Plaintiffs' Section 11 claims also applies to Plaintiffs' Rule 10b-5 claims, to the extent the Rule 10b-5 claims are based on the prospectuses. It bears repeating, then, that as a matter of law, there are no misrepresentations in, or material omissions from, the IPO Prospectus. Also, as a matter of law, there are no misleading statements in, or material omissions

from, the Debenture Prospectus, aside from possible errors by Deloitte in the 1987 financial statements.

Plaintiffs also base their Rule 10b-5 claims, though, on alleged fraudulent conduct by the defendants other than the prospectuses. Each defendant, without conceding that it engaged in any misleading conduct, moves for summary judgment on the ground that Plaintiffs cannot show scienter on the part of the defendants. The court addresses the evidence on scienter as to each defendant in turn.

A. *The Officer Defendants*

Aside from the prospectuses, Plaintiffs allege in conclusory fashion that the Officer Defendants violated Rule 10b-5 by misleading "press releases, filings with the SEC, statements to analysts, etc." The Officer Defendants overall pattern of conduct, though, rebuts any inference of knowing or reckless conduct on their part. If WOW's officers were bent on committing fraud, it is not likely that they would have provided such detailed risk disclosure in the prospectuses. Furthermore, if, as Plaintiffs allege, the Officers knew that WOW was heading for financial disaster, they probably would have bailed out of their substantial stock holdings. Each of the Officer Defendants, by contrast, held onto most of their WOW stock and incurred the same large losses as did the Plaintiffs themselves. Stein did not sell any of his holdings until after WOW filed for bankruptcy. Pezzani did not sell at all. Kingsboro sold only a small fraction of his stock, and that was pursuant to a prearranged plan developed by his financial advisor.

In addition, each of the Officer Defendants has submitted an affidavit stating that they acted in good faith regarding all of their dealings with WOW.

Plaintiffs' slim evidence of specific facts does not give rise to a inference of scienter when considered with the Officer Defendants' evidence. Plaintiffs point to statements attributed to defendant Kingsboro in the magazine *California Business* in 1986, before the class period began. Plaintiffs allege that Kingsboro's statements in the article were misleading.[14] WOW's public relations firm wished to reprint and circulate the magazine article, which was largely favorable to WOW. WOW's management, however, decided not to do so after consultation with their attorneys. Plaintiffs argue that the fact that the statements in the article were never formally corrected is probative of scienter on the part of the officers, even though the Officer Defendants do not concede that the statements were false, and Plaintiffs have no evidence on this point.

Plaintiffs, however, neglect to mention three key facts that rebut any inference of scienter. First, even if the statements in the article were false, WOW decided against reprinting the article. Second, the IPO Prospectus provided substantial risk disclosure that would have overwhelmed any misleading effect the magazine article could have had on the market. If the Officer Defendants were attempting to mislead the market, they would not have provided such ample risk disclosure to investors.

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[14] Plaintiffs do not submit any evidence showing that any of the statements were misleading. For that matter, Plaintiffs do not even point out to the court exactly which statements in the article they claim are misleading.

Third, Plaintiffs do not have any evidence to show that Kingsboro knew or could have known that the statements attributed to him in the article were false.

Plaintiffs also point to a statement Kingsboro made to the press in connection with WOW's earnings report for the fourth quarter of fiscal 1987. Kingsboro attributed the drop in WOW's earnings to "substantial investment in engineering and product development." Plaintiffs contend that it was due in fact to decreased sales. However, WOW did actually invest substantially in engineering and product development, and Plaintiffs have no evidence to suggest that Kingsboro's statement was false.

Plaintiffs' evidence shows only that they will grasp wildly at any straw in hope of saving their securities fraud claims against the Officer Defendants. There is no evidence of scienter on the part of any of the Officer Defendants. They are entitled to summary judgment on Plaintiffs' Rule 10b-5 claims.

B. *The Underwriter Defendants*

Plaintiffs' Rule 10b-5 claims against the Underwriter Defendants are based almost exclusively on the prospectuses, which, as the court discussed at *supra* part IV., do not support any inference that Plaintiffs were misled by these defendants.

Plaintiffs' claim against Dean Witter is based entirely on the IPO Prospectus. Thus, Dean Witter is awarded summary judgment on Plaintiffs Rule 10b-5 claim.

Aside from the prospectuses, the only alleged fraudulent conduct on the part of Smith Barney is an August

14, 1987 analyst report prepared by Stephen Handley of Smith Barney which recommended WOW stock to investors. Even though this report actually downgraded Smith Barney's earlier recommendation on WOW from "long term buy" to "accumulate," Plaintiffs contend that it was misleading. However, an analyst report containing opinions made in good faith is *per se* not made with scienter. *Software Toolworks*, 789 F.Supp. at 1501. Plaintiffs do not challenge the good faith basis for Handley's recommendation. Thus, summary judgment is awarded to Smith Barney on Plaintiffs' Rule 10b-5 claims.

C. *Deloitte*

As mentioned above, Deloitte was responsible for the 1987 financial statements that appear in the Debenture Prospectus. Plaintiffs have presented evidence, in the form of the declaration of an expert witness, that Deloitte erroneously recognized revenue on certain of WOW's transactions, which according to Plaintiffs makes the financial statements misleading under Rule 10b-5. This evidence creates a genuine issue of fact on this element of Plaintiffs' Rule 10b-5 claim.

To survive summary judgment, however, Plaintiffs also must come forward with evidence from which a jury could infer scienter on the part of Deloitte. Even assuming that Deloitte was incorrect in recognizing the revenues, Deloitte has not violated Rule 10b-5 unless it acted knowingly or recklessly in erroneously recognizing the revenues.

Deloitte has submitted evidence showing that it extensively investigated, carefully addressed, reasonably resolved, and thoroughly documented every transaction where Plaintiffs allege revenue was improperly recognized. Also, Deloitte submits the declarations of its accountants that recognition of the revenue was proper in accordance with Generally Accepted Accounting Principles ("GAAP"). The thoroughness of Deloitte's investigation into the transactions in question certainly meets Deloitte's burden of showing that there is no genuine issue of fact on the issue of scienter.

Plaintiffs respond to Deloitte's evidence with the declaration of Albert Rossi, an expert witness according to Plaintiffs. Rossi's testimony, in substance, is that for everything Deloitte's accountants did, he would have done more, and that in his opinion, the revenues were improperly recognized under GAAP. Rossi concludes that "[t]he danger that Deloitte's audit opinion and the financial statements which Deloitte audited would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it."

As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case. *Apple Computer,* 886 F.2d at 1116. "However, where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert.' " *Id.* An expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any inference of bad faith. *See Software Toolworks,* 789 F.Supp. at 1504 n. 30.

Here, Rossi's conclusory opinion that Deloitte's accountants had a mental state of knowledge or recklessness is not enough to allow a jury to infer scienter. Rossi's opinion is not based on specific facts that shed light on the mental state of Deloitte's auditors, and from which the jury on their own could infer scienter. Rather, Rossi is drawing his conclusion based on a record that conclusively rebuts any inference of scienter. *See Apple Computer,* 886 F.2d at 1118 (no inference of scienter where overall pattern of conduct inconsistent with bad faith). As such, Rossi's opinion is more probative of Plaintiffs' desperation to keep Deloitte, a "deep pocket," involved in this lawsuit than it is on the issue of whether Deloitte acted with scienter. Rossi's declaration does not help Plaintiffs survive Deloitte's motion for summary judgment.[15]

The court holds that as a matter of law Plaintiffs cannot establish scienter on the part of Deloitte. Deloitte is awarded summary judgment on Plaintiffs' Rule 10b-5 claims.

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[15] The court wishes to make clear that it is not striking Rossi's declaration, but granting summary judgment notwithstanding it.

Interestingly, this is not the first time that a district court has awarded summary judgment to an auditor on the scienter issue in the face of a declaration by Rossi. In *Software Toolworks,* the plaintiffs' asserted a Rule 10b-5 claim against Deloitte. After finding nothing in the record indicating scienter, the court awarded summary judgment in favor of Deloitte, even though an expert had opined that Deloitte had acted knowingly or recklessly. *See Software Toolworks,* 789 F.Supp. at 1504-10. Deloitte has informed the court that Rossi was the expert whose testimony was rebuffed by the court in that case.

D. *Plaintiffs' Insider Trading Claims*

The only colorable Rule 10b-5 claim that Plaintiffs allege against defendants Howenstein, Margolis, Abercrombie, Robinson, and WOW Shares Partnership is for insider trading.[16] Though the Ninth Circuit has not expressly recognized a private right of action under Rule 10b-5 for insider trading, other courts have implied this right. *See, e.g., Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 94-95 (2d Cir.1981).

Plaintiffs assert that since these defendants sold some of their shares in WOW prior to WOW's financial collapse, they must have known of some information, not already known to the market, that signalled WOW's imminent doom. Plaintiffs "evidence," though, consists of mere speculation and conclusory allegations. For example, according to Plaintiffs, Howenstein, as a director of WOW, must have had knowledge of inside information. Plaintiffs allege, without any proof, that Howenstein sold

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[16] Plaintiffs also allege that Howenstein and Margolis violated Rule 10b-5 in connection with the IPO Prospectus and the Debenture Prospectus, but the court has held that none of the statements in the prospectuses for which these defendants would be responsible are actionable under Rule 10b-5. *See supra* part IV.

Plaintiffs also allege, as a separate basis for their Rule 10b-5 claim, that Howenstein and Margolis violated Rule 10b-5 by "misrepresentations and omissions during the class period." Nowhere in their memorandums submitted in opposition to these motions do Plaintiffs specify what these alleged misrepresentations or omissions were. The court assumes that this is because there is no evidence to support these allegations. Thus, this portion of Plaintiffs' claim presents no genuine issues of fact, and summary judgment is appropriate.

some of his shares of WOW stock based on information not known to the market, as opposed to information disclosed by WOW.

Furthermore, Howenstein was Abercrombie's business manager, so Howenstein had many opportunities where he could have tipped Abercrombie on inside information. Since Abercrombie later sold a portion of her stock, she too must be guilty of insider trading, according to Plaintiffs. Plaintiffs also point out to the court that the president of Robinson met with Howenstein on numerous occasions, as if this was some sort of smoking gun that implicates Robinson in this alleged scheme of insider trading.

Plaintiffs follow a similar line of reasoning regarding Margolis and WOW Shares Partnership. Margolis, a director of WOW, had access to inside information. Again, without any proof, Plaintiffs allege that when Margolis sold a portion of his shares, it was based on this inside information. Since Margolis was a partner in WOW Shares Partnership, he had the opportunity to tip the other partners on inside information. WOW Shares Partnership sold some of its shares. Thus, according to Plaintiffs, illegal insider trading by WOW Shares Partnership also must have occurred.

Plaintiffs contend that their evidence is enough to survive summary judgment on their claims of insider trading. The evidence, though, shows only that the opportunity for insider trading existed. Plaintiffs cannot survive summary judgment merely by showing that the opportunity existed. Plaintiffs must point out with specificity, and present some proof of, the material nonpublic

information that was allegedly traded upon. In this case, after years of discovery, Plaintiffs cannot point to any bit of information traded on by these defendants that was not already known to the market. This speaks to the merits of their claims.

Moreover, even if there were some evidence that these defendants' sales of WOW stock were based on inside information, Plaintiffs have submitted no evidence from which the jury could infer scienter. "Insider trading in suspicious amounts or at suspicious times is probative of scienter." *Apple Computer*, 886 F.2d at 1117. But in this case, when one considers the amounts traded, Plaintiffs' claims appear fantastic. These defendants sold only a small portion of their holdings in WOW. Of course, an insider trader may not always trade all his shares in the company for which he possesses the inside information; the trader may hold on to a portion of his shares to hedge against the unforseen or to obscure the insider trading from the SEC. Here, however, Plaintiffs' allegation is essentially that these defendants possessed inside information on WOW's imminent collapse, so one would expect that they would have sold a good proportion of their holdings.

On the contrary, most of these defendants sold only a minuscule fraction of their holdings in WOW,[17] and

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[17] Robinson was the only defendant that sold a majority of its shares in WOW. Robinson, however, has submitted unchallenged evidence that it sold its shares because it faced a pressing need to service a huge debt incurred from overinvesting in real estate. Moreover, Robinson sold its stock according to a prearranged plan that conformed to SEC regulations. This rebuts any inference of scienter on the part of Robinson.

ended up reaping the same large losses as did Plaintiffs when WOW collapsed. For example, Howenstein sold only 50,000 shares before WOW's bankruptcy, though he possessed over 970,000. Abercrombie sold only about fourteen percent of her shares, holding onto approximately 2,870,000 shares that became essentially worthless after WOW's bankruptcy. Some of the partners in WOW Shares Partnership who supposedly possessed inside information did not sell at all.

In sum, with this evidence, no reasonable jury could find that insider trading had occurred, or that these defendants acted with scienter. Plaintiffs' Rule 10b-5 claims against Howenstein, Margolis, Abercrombie, WOW Shares Partnership, and Robinson are without merit. Summary judgment is granted in favor of the defendants on these claims.

VII. PLAINTIFFS' CLAIMS OF SECONDARY LIABILITY

Plaintiffs' Second and Ninth Claims for Relief allege claims of secondary liability under Section 20 of the Exchange Act, 15 U.S.C. § 78t (a), and Section 15 of the Securities Act, 15 U.S.C. § 77o, respectively. These sections provide that any defendant who controls a person liable under the securities laws is jointly and severally liable to the same extent as the controlled person.[18]

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[18] Section 20 of the Exchange Act provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally." 15 U.S.C.

In this case, the court has held that none of the defendants is liable under the federal securities laws. There being no primary liability, there can be no secondary liability. Thus, the court grants summary judgment for defendants on these claims.

VIII. PLAINTIFFS' STATE LAW CLAIMS

Plaintiffs' Third and Fourth Claims for Relief allege claims for state law fraud and negligent misrepresentation, respectively. Because the court intends to dismiss the federal claims in this case, it declines to further exercise its supplemental jurisdiction over Plaintiffs' state law claims.[19]

IX. CONCLUSION

When a company fails, it does not automatically mean that a violation of the securities laws has occurred. There are a number of risks involved whenever one invests in any company. The function of the federal securities laws is to provide investors with full disclosure of

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§ 78t (a). This section creates joint and several liability for Rule 10b-5 violations.

Section 20 of the Securities Act provides that "[e]very person who . . . controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally." 15 U.S.C. § 77o. This section creates joint and several liability for violations of Section 11 and Section 12(b) of the Securities Act.

[19] "The district courts may decline to exercise supplemental jurisdiction over a claim . . . if . . . the district court has dismissed all claims over which it has original jurisdiction. . . ." 28 U.S.C. § 1367(c)(3).

these risks, and to prevent fraud. The securities laws do not insulate investors against stock downturns which are caused by events that were not foreseeable to the company's management, nor do they provide insurance against risks that were disclosed to investors at the time they purchased the securities.

In this case, WOW's investors took a gamble, as do all investors. They lost. Holders of shares and Debentures knew that WOW was not a diversified company. Its success was based on only two major products, Teddy Ruxpin and Lazer Tag. Also, WOW's precarious cash position was not concealed from these investors; it was adequately revealed in both the IPO Prospectus and the Debenture Prospectus. It was obvious to any reasonable investor that if either of WOW's two products were to lose favor with consumers, the company would be devastated. Though WOW's failure was extraordinary, the material risks involved in investing in WOW were adequately disclosed to potential investors.

Plaintiffs have submitted hundreds of pages to this court in an effort to create a genuine issue of fact. Using tortured reasoning, convolution of the issues, and the benefit of hindsight, they point to the most innocuous of optimistic language, and the most immaterial of omitted facts, and claim that they were somehow misled as to the nature of their investment. The court has thoroughly reviewed the record, and it concludes that there is no issue on Plaintiffs' claims under the federal securities laws that can be submitted to the jury. For the reasons set forth above, no defendant is liable for any statement in, or omission from, either the IPO Prospectus or the Debenture Prospectus. Moreover, there is insufficient evidence,

as a matter of law, for the jury to find intent to deceive or defraud on the part of any defendant in connection with WOW's securities offerings.

The defendants' motions for summary judgment are GRANTED. This action is hereby DISMISSED.

IT IS SO ORDERED.

JUDGMENT

In accordance with the order entered by the court herein, summary judgment is GRANTED on Plaintiffs' federal claims in favor of the following defendants:

> Angelo M. Pezzani; Donald D. Kingsboro; Richard B. Stein; John B.Howenstein; Barry H. Margolis; Deloitte & Touche; Smith Barney, Harris Upham & Co., Inc.; Dean Witter Reynolds, Inc.; Josephine E. Abercrombie; Worlds of Wonder Shares Partnership; and Robinson Interests, Inc.

Plaintiffs' state law claims are hereby DISMISSED.

IT IS SO ORDERED.

ORDER DENYING PLAINTIFFS' MOTION TO RECONSIDER UNDER FED.R.CIV.P. 59; 60

I. INTRODUCTION

This action arises out of the collapse of Worlds of Wonder, Inc. ("WOW"), a high-technology toy company. Plaintiffs, a class of purchasers of WOW stock and debentures, brought an action under the federal securities laws against various individuals and firms involved in WOW's securities offerings. On January 20, 1993, this court

entered an Order granting summary judgment in favor of every defendant (the "Order"). See page 850. Plaintiffs now move the court to reconsider its Order.[1]

II. STANDARD OF REVIEW ON MOTIONS TO RECONSIDER

This court has the inherent power to modify or change its orders to correct a mistake or error. 6A *Moore's Federal Practice* ¶ 59.07 (1991). However, a motion for reconsideration is not the proper vehicle for revisiting issues that were decided, *Van Skiver v. United States*, 952 F.2d 1241, 1243 (10th Cir.1991), or for a "recapitulation of the cases and arguments considered by the court before rendering its original decision," *Starr v. JCI Data Processing Inc.*, 767 F.Supp. 633, 635 (D.N.J.1991). The party moving for reconsideration must show more than a disagreement with the court's decision; the court should not grant the motion unless there is a need to correct a clear error of law or prevent manifest injustice. *See Kern-Tulare Water District v. City of Bakersfield*, 634 F.Supp. 656, 665 (E.D.Cal.1986), *aff'd in part and rev'd in part on other grounds*, 828 F.2d 514, *cert. denied*, 486 U.S. 1015, 108 S.Ct. 1752, 100 L.Ed.2d 214 (1988).

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[1] Plaintiffs filed their notice of appeal to the Ninth Circuit Court of Appeals on February 18, 1993.

III. DISCUSSION

Plaintiffs filed two separate motions to reconsider. Plaintiffs filed a "Motion for Reconsideration and Alteration and Amendment of Judgment in Favor of Officer and Director Defendants and Defendant Smith Barney, Harris Upham & Co., Inc." In this motion, plaintiffs ask the court to reopen the case to reconsider issues that the court already decided. Specifically, they ask the court to reconsider its application of the "bespeaks caution" doctrine, and to reevaluate each of plaintiffs' contentions that certain statements in or omissions from WOW's prospectuses misled investors. This motion presents no new issues of law or fact. Therefore, the court denies this motion in its entirety.

Plaintiffs also filed a "Motion for Reconsideration and Alteration and Amendment of Judgment in Favor of Defendant Deloitte and Touche." Again, this motion presents no newly discovered facts or law showing that the court's Order was in error. Plaintiffs simply challenge the court's analysis. However, the court believes that some clarification of its Order would be helpful to the parties.

A. *The "Loss Causation" Defense of Section 11(e)*

To recall, Deloitte & Touche ("Deloitte") was WOW's independent auditing firm. Deloitte prepared and certified the financial statements WOW included in the prospectus for its debenture offering (the "Debenture Prospectus"). WOW's debentures greatly decreased in value after WOW defaulted on its first interest payment to debenture holders and declared bankruptcy.

The plaintiff subclass of debenture holders claims it is entitled to damages under Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k. According to plaintiffs, the financial statements in the Debenture Prospectus overstated WOW's net revenues for fiscal 1987 by 14.3%[2]. Deloitte allegedly violated Section 11 by allowing this misleading information to appear in the Debenture Prospectus with Deloitte's certification.

Section 11(e) allows a prevailing plaintiff "to recover such damages as shall represent the difference between the amount paid for the security . . . and (1) the value thereof at the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit. . . . " 15 U.S.C. § 77k(e). However, Section 11(e) allows a defendant to avoid liability by proving that the decline in the price of the security resulted from factors "other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is being asserted, not being true." *Id.*

This court granted summary judgment to Deloitte based on its Section 11(e) "loss causation" defense.[3] (Order at 41.) The court held that the market price of

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[2] In their opposition to Deloitte's motion for summary judgment, Plaintiffs submitted the testimony of an expert witness that Deloitte erroneously recognized revenue on some of WOW's major transactions in fiscal 1987. The 14.3% figure is supplied by plaintiffs' counsel based on this expert's declaration.

[3] The court expressly did not reach the merits of Deloitte's "due diligence" defense.

WOW's debentures declined for reasons other than the alleged overstatement of revenues by Deloitte. The court found that Deloitte's alleged errors never were disclosed to the public. Since there was no public disclosure of the fact that WOW's 1987 revenues may have been overstated, the market could not possibly have reacted. (*See* Order at 866-67.) The court found instead that the debentures declined in value because the market discovered that WOW was barely liquid, and faced increasing difficulties in selling its products. (Order at 866-67.)

Plaintiffs contend, as they did in opposing Deloitte's motion for summary judgment, that they purchased the debentures at an artificially high price due to the market's reliance on Deloitte's alleged errors. Therefore, when WOW collapsed, plaintiffs suffered a greater loss than they otherwise would have suffered. Plaintiffs claim that this loss is recoverable under Section 11.

The argument pressed by plaintiffs is best illustrated by the district court in *In re Washington Public Power Supply System Securities Litigation*, 650 F.Supp. 1346 (W.D.Wash.1986) [hereinafter *Washington Power*].[4] In that case, the court proposed the following hypothetical: An investor buys stock in a shipping venture which owns one single vessel. The prospectus overstates the amount of capacity in the boat. However, the prospectus discloses truthfully that the vessel will not be insured. Suppose a storm destroys the vessel, and the investor's stock

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[4] This case was not brought to the court's attention by either Plaintiffs or Deloitte before its Order was entered.

becomes worthless. What damages would the investor be entitled to? *See id.* at 1353-54.

The court in *Washington Power* made the following observations:

> The misrepresentation may not be the cause of the loss; it is however, the cause of damage. By misrepresenting the capacity in the ship, the investor was induced to pay a certain price for stock in the venture. As a result of the misrepresentation, the investor paid more for the stock than it was worth. When the ship sank, the entire investment was lost. The investor, however, was injured by more than the true value of the investment because he paid an inflated price for the stock. The damages thus consist of two components: the value lost due to the casualty and the amount lost because he overpaid for the stock.

Id. The court concluded that the amount lost due to overpayment would be recoverable in an action under Rule 10b-5.[5] *Id.* Plaintiffs argue that under this reasoning, even if WOW's collapse is wholly unrelated to Deloitte's alleged errors, they are entitled to damages measured by the difference between the price they paid for the debentures and their "true value" at the time of purchase, that is, the price the debentures would have commanded from

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[5] Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10(b)(5), is promulgated pursuant to Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b). Rule 10b-5 creates a private right of action to remedy fraudulent conduct in connection with a securities offering.

the market in the absence of Deloitte's alleged misstatement of revenues. Plaintiffs now move the court to reconsider this portion of its Order.

To understand why Deloitte's "loss causation" defense of Section 11(e) applies in this case, one must consider the "fraud on the market" theory, on which plaintiffs rely. In a fraud on the market case, the plaintiffs do not have to prove individual reliance on the allegedly misleading information. Instead, the plaintiffs' claim that the misleading information was immediately disseminated throughout the market by those persons who did rely on it, thereby increasing the market price of the security. It necessarily follows under this theory that plaintiffs suffer no cognizable loss from the misleading information until the market learns of the falsehood of the information and adjusts accordingly. Until the false or misleading nature of the information is publicly disclosed, the price of the security remains inflated. Investors could sell their securities at any time before disclosure without suffering a loss.

It is helpful to consider a variation of the hypothetical set forth in *Washington Power* for illustration. Suppose the investor paid $100 for his stock in the shipping venture. This was the market price at the time of purchase. But unknown to the market, the boat's capacity is considerably less than was disclosed in the prospectus. If the true capacity were disclosed, the market price of the investor's shares would have been $75. Therefore, the investor's stock was overpriced by $25. Now suppose the boat is damaged in a storm, but does not sink. The market would react, and the price of the stock would decline, to perhaps $50 (to choose an arbitrary number).

If, however, the market has not yet learned the true capacity of the vessel, the stock is still overpriced by $25 (assuming all other variables affecting the shipping venture remain constant).

In the above example, the misleading prospectus did not cause the loss suffered by the investor. Under section 11(e), the defendant responsible for the error in the prospectus can prove that the investor's loss was caused by the storm, not by the misleading information about the boat's capacity. The defendant would be entitled to summary judgment.

Now assume instead that one day after the investor purchases the stock, the boat sinks in a storm, and the loss is total. This reduces the market value of the investor's stock to $0. Upon inspecting the wreckage, the investor learns of the mistake in the boat's capacity. He now claims he would have paid only $75 for his stock, and seeks to recover the overpayment of $25 from the person responsible for the misleading statement in the prospectus. There is no reason to change the analysis in the first example simply because the loss caused by the storm in this case is total. The storm, not the misleading prospectus, is still the direct cause of the loss. To allow recovery would convert the person responsible for the misleading information into an insurer against all possible casualties to the boat, not just those risks directly related to the defendant's misleading conduct.[6]

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[6] To be fair, recovery would only be for the amount overpaid ($25) and not the full amount of the casualty ($100). To allow recovery, then, would only put the defendant in the position of a partial insurer. However, the important point is that the

Thus, when plaintiffs proceed under a fraud on the market theory, the defendant is entitled to summary judgment on the loss causation defense of Section 11(e) upon an unrebutted showing that the misleading nature of the statements complained of was never revealed to the market. Indeed, this is the view of the small number of courts that have addressed this issue directly. *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir.1987); *In re Fortune Systems Sec. Litig.*, 680 F.Supp. 1360, 1368 (N.D.Cal.1987).

Plaintiffs cite to numerous cases which, according to plaintiffs, allow the recovery of the amount overpaid by investors due to the market's reliance on false or misleading statements. *See Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461 (9th Cir.1990), *rev'd on other grounds*, ___ U.S. ___, 112 S.Ct. 1311, 117 L.Ed.2d 532 (1992); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433 (9th Cir.1987); *Washington Power*, 650 F.Supp. 1346. These cases, however, all involve claims under Rule 10b-5 and not Section 11, and therefore are inapposite here.

It is no accident that the measures of damages for Section 11 violations and Rule 10b-5 violations are different. Rule 10b-5 is a catch-all provision that provides a remedy for any misleading conduct made in connection with the purchase or sale of securities, provided that the defendant possessed fraudulent intent, or scienter. The broad "loss causation" standard applied in the Rule 10b-5 cases cited by plaintiffs is judicially created to deter

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insurance would be for risks unrelated to the defendant's role in the securities offering. By including the "loss causation" defense in the statute Congress meant to exclude this result.

fraudulent conduct. The measure of damages, the difference between the price paid for the security and its "true value", is similar to the remedy provided in common law fraud cases.

By contrast, Section 11 is not a fraud provision. Section 11 applies to any misleading statements that appear in a prospectus. Section 11 does not require the plaintiff to prove fraudulent intent, or even negligence, on the part of the defendant. In order to balance the harsh, strict liability features of Section 11, Congress expressly has limited the damages to those directly caused by the defendant's misleading conduct. The remedy and the loss causation defense are provided by statute, and stand in stark contrast to the judge-made remedy for Rule 10b-5 violations.

For the above reasons, the court does not change its holding that Deloitte was entitled to summary judgment upon a showing that its alleged accounting errors never were disclosed to the market.

B. *Whether Deloitte's Alleged Errors Were Disclosed*

Of course, it is not necessary for Deloitte to admit publicly that it made errors in the Debenture Prospectus for the jury to find disclosure of the errors to the market. The market could have learned of Deloitte's errors indirectly through the disclosure of related information. Here, plaintiffs contend that the errors in WOW's 1987 financial statements in fact were disclosed to the market before plaintiffs filed this suit. Plaintiffs argue that WOW's public disclosure of adverse information shortly

after the debenture offering clued in the market to Deloitte's alleged overstatement of WOW's fiscal 1987 revenues.

After the debenture offering, WOW publicly disclosed information that adversely affected the price of the debentures. Specifically, WOW disclosed that it ran out of cash in the middle of fiscal 1988, due in part to declining sales, and in part to inability to collect past due accounts receivable. Plaintiffs contend that the market must have learned of Deloitte's overstatement of WOW's fiscal 1987 revenues from these disclosures.

The court fails to see the logic in plaintiffs' argument. The amount of revenue posted by a company during a prior year is a number that exists only on paper to reflect total sales during that year. The amount of actual cash the company has access to at the moment is not necessarily related to its total sales in the previous year. This is a separate issue, and investors are savvy enough to look in places other than the company's statement of revenue to find out the relevant facts on the company's immediate access to cash.[7] The market would not interpret WOW's running out of cash as a signal that its revenues for the previous year were overstated.

Moreover, even if WOW's lack of access to cash was related to Deloitte's alleged mistake, the Debenture Prospectus truthfully disclosed all the relevant facts on

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[7] A company's liquidity, or immediate access to cash, is evidenced by factors other than total sales, such as the company's ability to collect accounts receivable and the amounts of cash available on existing bank credit lines. It is common for a company to disclose these factors in a prospectus.

WOW's continued liquidity elsewhere in the Debenture Prospectus. (Order at 866.) The Debenture Prospectus clearly warned that WOW's access to capital in the near future was suspect. It disclosed that WOW's existing bank credit lines were tapped nearly to the limit, and that the company would be severely damaged by an anticipated shortfall in demand. *Id.* In short, the risk that WOW would run out of cash was a risk that WOW's investors assumed when they purchased the debentures. Deloitte is not liable for the losses plaintiffs incurred when this possibility became reality.

Plaintiffs present no other evidence of any disclosure from which the market possibly could have gleaned that Deloitte's statement of WOW's fiscal 1987 revenues was in error. The court considered the merits of Deloitte's defense in its Order. Viewing the evidence in the light most favorable to the plaintiffs, this court held that "[t]here was no disclosure of [Deloitte's alleged accounting errors] to the public at any time before this lawsuit was initiated." (Order at 866-67.) Thus, as explained above, these alleged errors could not have affected the market price of WOW's debentures. Deloitte is not liable under Section 11 for any part of plaintiffs' losses.

C. *Plaintiffs' Rule 10b-5 Claims*

This court granted summary judgment in favor of Deloitte on plaintiffs' Rule 10b-5 claim on the ground that, as a matter of law, plaintiffs' evidence did not establish scienter on the part of Deloitte. (Order at 870-71.) Plaintiffs ask the court to reconsider this holding.

Plaintiffs argue that "[t]he Order inexplicably dismisses Mr. Rossi's exhaustive, highly detailed, 81-page declaration as 'conclusory' and unaccountably disregards plaintiffs' other evidence." (Plaintiffs' Mem. at 23.) The court did not disregard any evidence presented by plaintiffs. On the contrary, it held that plaintiffs' evidence, even when viewed in the light most favorable to plaintiffs, did not have enough probative value to rebut Deloitte's evidence showing a lack of scienter. Not all of plaintiffs' evidence was worthy of comment in the court's Order. Plaintiffs' motion to reconsider on this issue is denied.

As to Rossi's declaration, the number of pages submitted to the court has nothing to do with the weight the evidence is entitled to. As the court held, "Rossi's opinion is not based on specific facts that shed light on the mental state of Deloitte's auditors, and from which the jury on their own could infer scienter. Rather, Rossi is drawing his conclusion based on a record that conclusively rebuts any inference of scienter." (Order at 870-71.)

Plaintiffs' evidence and arguments on this issue have already been considered by the court. Their motion to reconsider is denied.

IV. CONCLUSION

In accordance with the foregoing, plaintiffs' motions to reconsider the court's January 20, 1993 Order and entry of judgment are DENIED.

IT IS SO ORDERED.

APPENDIX C

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In Re: WORLDS OF WONDER SECURITIES LITIGATION,	
ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, as Trustee for the Florida Municipal, Inc., Restated Defined Benefit Trust and Plan; SYLVIA WIND, on behalf of themselves and the certified class of purchasers of securities of Worlds of Wonder, Inc.,	Nos. 93-15321; 93-15535 D.C. No. CV-87-05491-SC ORDER (Filed Mar. 27, 1995)
Plaintiffs-Appellants,	
v.	
ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS, UPHAM & CO.; DEAN WITTER REYNOLDS, INC.; JOSEPHINE E. ABERCROMBIE; WORLDS OF WONDER SHARES PARTNERSHIP; ROBINSON INTERESTS, INC.,	
Defendants-Appellees.	

Before: FLETCHER, HALL and WIGGINS, Circuit Judges.

The panel has voted to deny appellants' petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

APPENDIX D

Civil Liabilities on Account of False Registration Statement

Sec. 11. (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue –

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement

in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof –

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and

(C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as

an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.